Stakeholder Proceedings Regarding Ratemaking and Maine Universal Service Support Mechanisms for Provider of Last Resort Telephone Service

REPORT OF THE
MAINE PUBLIC UTILITIES COMMISSION

Presented to the
Joint Standing Committee on Energy, Utilities and Technology
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Telecommunications Report Outline

List of Acronyms

CLEC:	Competitive Local Exchange Carrier
FCC:	Federal Communications Commission
ILEC:	Incumbent Local Exchange Carrier
MPUC:	Maine Public Utilities Commission
MUSF:	Maine Universal Service Fund
POLR:	Provider of Last Resort
TAM:	The Telephone Association of Maine
USF:	Universal Service Fund
VoIP:	Voice over Internet Protocol
VSP:	Voice Service Provider

EXECUTIVE SUMMARY

At the direction of the 125th Legislature, the Maine Public Utilities Commission conducted a stakeholder proceeding over the course of the summer and fall of 2012 for the purpose of establishing whether a consensus could be achieved among various carriers of telecommunications services (wireline, wireless, and facilities-based Voice over Internet Protocol (VoIP)), and the Public Advocate, regarding methodologies that might be employed to establish rates and the amount of Maine Universal Service Fund (MUSF) support for Provider of Last Resort (POLR) service. No such consensus was achieved.

The lack of consensus in the area of rate-setting and MUSF support for carriers assigned by law the responsibility of offering POLR service (the only form of telephone service that remains subject to economic regulation by the Commission) is not surprising given the differing economic interests and correspondingly disparate policy views held by the stakeholders regarding the proper role of a universal service funding mechanism in a competitive marketplace. These various views of the proper role of the MUSF lead to drastically differing positions regarding how much the size of the fund should be allowed to grow (if at all) in the event that a telephone carrier assigned POLR obligations requests and obtains support payments in connection with its POLR service offerings.

The Commission's independent view is that the best way to set POLR rates is to allow a carrier to petition for a POLR rate increase supported by whatever evidence that it believes will best demonstrate the amount of revenues it needs in order to provide POLR service. In such a filing, the petitioner would be free to advance the methodology that it believes is best suited to the case. The methodology selected by the POLR service provider would then be analyzed and tested against alternative means of rate setting during the course of an adjudicatory proceeding in which all interested parties would be entitled to participate. The Commission believes that an "embedded cost revenue requirement" analysis should be required in order to establish a ceiling on the total amount of MUSF support any particular POLR carrier may receive. The Commission already possesses the statutory authority necessary to conduct such proceedings, and it has a long history of experience in conducting various types of rate setting proceedings.

With respect to establishing what amount of MUSF support, if any, to award to a POLR carrier following a POLR rate case, the Commission recommends that it be authorized to conduct "reverse auctions" whereby competitive providers could bid for the right to receive MUSF support in exchange for an agreement to replace the incumbent as the POLR carrier in the incumbent's service territory. A reverse auction, and the selection of the lowest cost, qualified bidder, has the potential to minimize the amount of money that would need to be collected from all users of telecommunications service and redistributed in support of POLR service. Such an auction would also have the benefit of establishing whether claims of robust ubiquitous competition have merit, since if those claims are true, non-incumbent and non-wireline carriers would have a strong incentive to take advantage of the opportunity for support. Statutory authorization for the implementation by the Commission of a reverse auction process would be appropriate notwithstanding that such a process, while novel, may well be permissible under existing law.

COMMISSION REPORT

I. Regulatory Reform and the Stakeholder Process

The Maine Public Utilities Commission (the "MPUC" or the "Commission") submits this report, pursuant to P.L. 2011, Chapter 623, Section A-25, enacted by the 125th Maine State Legislature as part of a comprehensive reform of telecommunications regulation in Maine. Section A-25 provides:

> The Public Utilities Commission shall convene a stakeholder group to create an appropriate framework for establishing rates for provider of last resort service, including methodology, appropriate cost considerations and standards for the availability and amount of support from a universal service fund established in the Maine Revised Statutes, Title 35-A, section 7104. The commission shall seek to find the most effective framework to avoid rate deaveraging and that keeps rates in high-cost areas as low as is reasonably possible. The commission shall invite the participation of as broad and inclusive a group of entities as possible, including the Office of the Public Advocate and representatives of affected telecommunications industry entities or groups and consumer interest entities or groups, and shall involve those entities or groups in a collaborative process that seeks to find as much common ground and agreement as reasonably possible. The commission shall submit a report to the joint standing committee of the Legislature having jurisdiction over utilities and technology matters by January 15, 2013 describing the work of the stakeholder group, where agreement was found and where disagreements remain, the commission's recommendations and the positions of the stakeholders on those recommendations.

Prior to the enactment in 2012 of the regulatory reforms in the telecommunications area, the Commission submitted to the Legislature a Plan to Reform Telecommunications Regulation pursuant to a Resolve adopted in 2011. The Plan is available at www.maine.gov/tools/whatsnew/attach.php?id=335240&an=1. The Plan includes a comprehensive description of the economics of the telecommunications industry in Maine and of the impacts that competition has had on the viability of traditional regulatory approaches to ratemaking. Those observations are not repeated in this Report.

Under regulatory reform, "provider of last resort" (POLR) service, as defined in 35-A M.R.S.A. § 7201(7), is the minimum level of basic local exchange service that all Maine consumers are entitled to purchase at just and reasonable, regulated rates. POLR service is now the only retail telecommunications service that is subject to the

Commission's regulatory oversight.[1] The statutory obligation to offer POLR service is currently assigned to the various incumbent local exchange carriers (ILECs) operating in the state. Although the regulatory reform legislation established initial rates for POLR service at the same rates at which the ILECs offered "basic local service" prior to enactment of the statute, the legislation did not address the question of what mechanism the Commission should employ to set rates for POLR service in the future. Nor did it mandate how the Commission should evaluate requests by POLR carriers for ratepayer-provided financial support from the Maine Universal Service Fund (MUSF).[2] Those questions were the subject of the stakeholder proceeding conducted by the Commission, in Docket 2011-224, from May through December, 2012.

The Commission gave broad notice of the stakeholder proceeding and conducted six stakeholder meetings between June and November, 2012. The wireless, voice over internet protocol (VoIP), cable voice, and traditional telephone industries, and the Public Advocate were represented. The participants were encouraged to file written proposals and comments to the proposals of other stakeholders prior to each meeting. These proposals and comments were the subject of in-depth discussion among the stakeholders, the Commissioners, and Commission Staff. Between stakeholder meetings, the participants refined their proposals and comments.[3] Several of the stakeholders requested, and were afforded, an opportunity to make extended presentations to the group at the meetings. For instance, FairPoint arranged for representatives from CostQuest, a private consulting firm that has developed proprietary telecommunications cost-modeling software, to give a presentation regarding the capabilities of a forward-looking cost model in the context of rate-setting

[1] The regulatory reform statute did not remove from the Commission its authority over wholesale telecommunications matters or its jurisdiction to enforce provisions of the federal telecommunications statutes.

[2] The MUSF is a surcharge levied on all consumers of telephone service in Maine (be it provided by cable, wireless, internet, or a traditional telephone company) via a monthly fee assessed on each customer.

[3] In addition to the stakeholders that participated in the stakeholder meetings, Critical Alert Systems (CAS), d/b/a Northeast Paging, a provider of radio paging services for approximately 45,000 consumers in Maine (the only provider of such services operating in Maine), also submitted written comments. CAS suggests that as a provider of a service that is critical to the emergency management activities of hospitals, doctors, utility workers and municipal employees, it should not be required to contribute to a MUSF program that is designed to provide subsidies for telephone service providers. Under 35-A M.R.S.A. § 7104(3), all voice network service providers *and providers of radio paging service*, must contribute to the MUSF. Based upon its revenues in 2011, CAS contributed $9,500 to the MUSF. A copy of the comments of CAS, including its proposed statutory amendment that would relieve radio paging service providers from the MUSF requirement, is attached in an appendix to this report. In the Commission's view, adoption of such a revision would not have an appreciable effect on the amount of MUSF contributions required voice network service providers.

proceedings. Likewise, TAM arranged for a representative of the consulting firm BerryDunn to explain the Association's simplified "spreadsheet" proposal for POLR ratemaking and support analysis. The Public Advocate's expert, Dr. Robert Loube, also participated extensively at the group meetings. The stakeholder proposals and comments were refined over the course of the process. On November 29, 2012, the Commission presented a draft of this report to all stakeholders and in preparing the final report has considered the responsive comments subsequently filed by the stakeholders on December 20, 2012. In addition, the final comments of the stakeholders are attached in an addendum to this report. The interim submissions made by the stakeholders over the course of the stakeholder proceeding (Docket No. 2011-224) are available for review on the Commission's electronic docket filing system.

II. Stakeholder Positions Summarized

There was no consensus among the stakeholders regarding any methodology for setting POLR rates or for determining the amount of MUSF support for POLR carriers going forward. This is hardly surprising because there exist among the stakeholders two very different views regarding the public policy purpose of a universal service fund in an era of competition in the telecommunications market.

In the ILECs' view, the purpose of the MUSF is to provide funds necessary to support those costs of maintaining and operating a network capable of providing POLR service which cannot otherwise be recovered through rates charged for both regulated POLR service and unregulated non-POLR services. The ILECs argue that MUSF support should be viewed as the cost to the State of a public policy that requires each ILEC to provide a basic level of telephone service to any customer within its service territory who desires to purchase that level of service. The ILECs claim that in the absence of full subsidization of network costs unrecoverable through rates it would be fundamentally unfair to require that they continue to provide POLR service in the unprofitable, high-cost segments of their territories while, at the same time, they are forced to compete in the market against carriers that are not subject to the same level of regulation under federal and state law.

The competitive providers (wireless, VoIP, and Time Warner Cable) advocate a much more limited role for MUSF support. These stakeholders claim that a technologically advanced, competitive marketplace has resulted in modern telecommunications services that many consumers prefer over the offerings of the traditional wireline ILECs. In the view of these carriers, a MUSF support program should not be expanded and perpetuated for the purpose of shoring up an antiquated and declining wireline telephone industry against competitive challenges. Moreover, such subsidies should not be disbursed for the purpose of supporting the revenues of the ILECs that have been lost through competition. This is especially so, they claim, because the MUSF is funded by fees collected from all consumers -- many of whom have rejected wireline service in favor of more advanced services or different types of service.

It would be preferable, in the view of the competitive providers, to narrowly target MUSF support to the maintenance of POLR service availability only in those ever-diminishing areas of the state where competitive options to POLR service do not currently exist (so-called "white spaces"). For instance, the Wireless and VoIP Coalition proposes that the MUSF be used to subsidize service only in those discrete areas of the state where a single provider offers service. Moreover, even when MUSF support is necessary, the Commission should carefully evaluate any request for funds by a POLR service provider in the context of an adjudicatory proceeding. To ensure that the size of the fund remains "modest," the competitive carriers recommend that a cap be established on the total size of the MUSF and that a POLR carrier seeking support payments be required to demonstrate that it has considered incremental revenue enhancement and/or cost reduction measures in the form of financial and operational restructuring, the sale or spin-off of a portion of the company's business, outsourcing of particular functions, mergers, joint ventures or the sale of assets. Excessive subsidization can also be avoided, according to Time Warner, by requiring that a POLR carrier raise its rates for POLR service to some minimum benchmark rate established by the Commission. Finally, the wireless and VoIP providers assert that there presently exists no crisis that would warrant the immediate expansion of the MUSF and, further, that the Commission should wait for the resolution of all outstanding issues regarding the recently adopted reformations by the FCC of the federal USF program in order to ensure that the state and federal support mechanisms do not work at cross purposes.

The significance of this divergence of views is not academic. The choice of either perspective as policy would dramatically impact the size of the MUSF. For instance, in its initial comments, FairPoint claimed that the budget of the MUSF, currently $8 million, needs to be increased immediately to $22 million on an "interim" emergency basis in order to accommodate the company's pressing need for additional revenue. FairPoint did not support with actual evidence its asserted need for immediate MUSF support. Instead, it claimed that an "interim" increase by $14 million in the size of the MUSF is undoubtedly reasonable because the company could actually justify a total MUSF budget that would grow from a starting point of $60 million to approximately $180 million in five years. Presently, FairPoint does not receive MUSF support. However pursuant to the regulatory reform statute, it is now eligible to request MUSF subsidies.

Needless to say, FairPoint's projection of the amount of MUSF support it claims to need in exchange for its obligation to offer POLR service was not subjected to the sort of rigorous analysis that would occur in a typical Commission adjudicatory proceeding. Indeed, it was not the purpose of the stakeholder process to undertake such an exhaustive financial and operational evaluation of any particular company's need for MUSF support. Rather, the primary purpose of the stakeholder process was to explore various possible frameworks for such an undertaking. However, even though FairPoint's projection is not supported by rigorous analysis, it does demonstrate the significant potential impact that adopting the ILECs' view of the public policy purpose of the MUSF support would have on the size of the fund.

In contrast, the competitive providers (none of whom are presently designated as POLR carriers) do not supply any estimate of the necessary size of a MUSF that would be used, as they recommend, solely for the purpose of ensuring that telecommunications remain available in the "white spaces." In addition, the wireless carriers have not provided reliable wireless network data that could be used to quantify the assertion that proliferation of wireless service has vastly reduced the extent of "white spaces" in Maine and thus substantially reduced the need for MUSF support of POLR service. Consequently, the Commission does not possess information demonstrating that in geographic areas where wireless service is the only alternative to ILEC service, the strength of the existing wireless signal throughout the service territory is adequate to deliver a service that is reasonably comparable to the wired local exchange service of an ILEC. General coverage information on file with the Connect Maine Authority and the Federal Communications Commission is insufficiently granular to provide a satisfactory understanding of precisely which customers in Maine do not have access at their residences to a strong wireless signal.[4] Notwithstanding these limitations of the presently available data, attached to this Report are maps depicting the locations of likely “white spaces” in Maine using that data.

Time Warner, which provides cable VoIP telephone service, is generally supportive of the use of a MUSF mechanism in which its customers (like all telephone customers) contribute to the fund through the assessment of MUSF fees to ensure availability of POLR service throughout Maine. However, Time Warner cautions against the adoption of a method for setting MUSF levels that is not empirically based. In addition, Time Warner asserts that MUSF subsidies should be focused on enabling the provision of affordable POLR service in high cost areas or areas where there exist no competitive alternatives to POLR service. In Time Warner’s view, the proposals advanced by TAM and FairPoint are more geared towards advancing a financial subsidy of the ILECs at the expense of imposing financial burdens on consumers who do not purchase telephone service from a POLR carrier.

The Office of the Public Advocate, in its comments, supports the concept of using a forward-looking cost model approach for setting POLR service rates provided that a traditional embedded cost analysis is performed to ensure that the disbursement of MUSF support does not generate excessive earnings. The OPA also cautions that without the use of an “embedded cost backstop,” there would be no incentive for a POLR service provider to actually invest in the modern network which a forward looking model would depict. The OPA suggests that a carrier might take the support generated by a model that calculates the POLR service provider's revenue requirement based upon the assumption that the costs are those of a newly constructed network, but would not necessarily actually build such a network. The OPA also suggests that any forward looking cost model should incorporate the particular characteristics of network construction in Maine (*e.g.*, burial of transmission wires is generally cost prohibitive) and also that the allowable return on investment should be focused on the portion of plant used to generate telephone, as opposed to broadband or long distance, revenues.

[4] Data compiled by the FCC regarding the number of Maine residents without wireline alternatives to ILEC service is imperfect in that FCC’s analysis assumes (incorrectly) that a competitive carrier that offers service to one location within a postal zip code offers service to all premises located in that zip code. Nonetheless, the data does reflect that the total number of Maine customers without any competitive wireline alternative is decreasing.

III. Commission Observations Regarding the Fundamental Issue Raised in the Stakeholder Proceeding

Traditionally, MUSF support has been collected and disbursed for the purpose of ensuring that an ILEC is able to provide comparable service at comparable rates to customers who reside in areas where the costs of providing service are relatively high. However, the universal service issue that has generated substantial disagreement among the stakeholders here is entirely different in character and scope. Specifically, the parties dispute whether and to what extent MUSF support should be provided in areas where there exist competitive alternatives to POLR service, and also whether or not MUSF support should be limited to areas in which the cost of providing POLR service is relatively high.

The essence of this disagreement is whether or not all consumers of telecommunications services in Maine should be required to subsidize a network operated by an ILEC that is used for the provision of POLR service by that ILEC. Currently, customers of wireless and cable VoIP service providers collectively pay more into the MUSF than ILEC customers. However, the wireless and cable VoIP carriers do not currently provide POLR service and, thus, are not entitled to receive support payments from the MUSF. This creates an obvious tension between the carriers whose customers are net payers of MUSF subsidies and the carriers who are net recipients of MUSF subsidies – a tension that has increased with the enactment of the Regulatory Reform legislation and the accompanying prospect of a larger MUSF. The size of the MUSF may grow in part because FairPoint may now, for the first time, receive MUSF support.[5] Resolution of this tension between net payers of MUSF fees and net recipients of MUSF support (and their respective customers) presents the fundamental, and unresolved, policy issue raised by the stakeholders. The dimensions of this disagreement have been increased by the legislative admonition to avoid price de-averaging for POLR service: that admonition has been used by the ILECs as support for their position that any revenue shortfalls due to competition, as well as the cost of providing POLR service should principally be addressed by MUSF support rather than by increasing rates.

IV. Commission Recommendations

The fundamental policy issue confronting the Legislature revolves around the question of which of two alternative views of the MUSF should guide the Commission's economic regulation of POLR service in the context of an increasingly competitive market for telecommunications service generally. To assist the Legislature in resolving the issues that will undoubtedly be brought before it by the same parties who were unable to reach consensus in the stakeholder process, we offer the following observations and proposal for establishing a going-forward methodology for setting POLR service rates and MUSF support. This proposal does not predetermine which

[5] In its comments, FairPoint has indicated that it requires a substantial amount of MUSF subsidy.

view of MUSF support should prevail. Rather, it suggests that time-tested ratemaking techniques in combination with competitive bidding may yield the optimal results in ensuring that POLR service remains available to all customers who desire it, at reasonable rates, while at the same time ensuring that public financial support necessary to subsidize POLR service is minimized by efficiently disbursing it to the least cost carrier willing to undertake the POLR service obligation.

A. The Commission should be required to conduct an adjudicatory revenue requirement case prior to approving a request for a POLR service rate increase or MUSF support

It has been many years since any ILEC has filed a request with the Commission to increase its rates. Presently, POLR service rates are set, by statute, at the rates that each ILEC charged for basic local exchange service prior to enactment of the reform statute. MUSF support disbursements are unchanged from the levels established at the time the Commission conducted comprehensive proceedings to adjust intrastate access rates, expand and synchronize basic calling areas for all customers, and set rates for the rural ILECs at the (then) Verizon level. These proceedings were intended to create rough parity in the rates paid by customers of Verizon (now FairPoint) and the “independent” ILECs. That process occurred eight years ago.

To ensure that a request by a POLR service provider to increase its rate for POLR service, and any concurrent request for increased MUSF support, does not result in excessive earnings for the carrier, we recommend that a comprehensive, adjudicatory revenue requirement case be conducted by the Commission to establish just and reasonable POLR service rates and MUSF support levels.

A traditional, “revenue requirement” rate proceeding in which the Commission identifies the investment, or rate base, upon which a utility is entitled an opportunity to earn a reasonable return, is complex. This is also known as an “embedded cost” revenue requirement analysis. A particularly difficult aspect of an embedded cost revenue requirement analysis for telephone utilities involves an effort to distinguish (or “separate”) those expenses and rate base infrastructure that are attributable to regulated, intrastate service ("jurisdictional" services) from those which relate to services such as interstate long distance and broadband – services which fall outside of a State’s regulatory jurisdiction (“non-jurisdictional” services). This apportionment is complex because the same physical plant (*i.e.*, switches, wires, utility poles) is used interchangeably to provide both “jurisdictional” and “non-jurisdictional” service. Nonetheless, there exist guidelines, in the form of FCC rules and methodologies as well as Commission precedent, which provide a rational basis for making the necessary jurisdictional assignment of the rate base and the associated expenses. An additional but related issue that will undoubtedly arise in the context of a revenue requirement analysis for a POLR service provider is the question of whether, and to what extent, rate base should be further adjusted to apportion the cost of a carrier’s physical plant between its use for the provision of POLR service and its use for the provision of other, now unregulated (or federally regulated) telecommunications services.

In the course of the stakeholder proceeding there emerged two alternative methodologies for conducting a POLR service rate case. The TAM companies proposed an abbreviated spreadsheet approach whereby a POLR service provider requesting a POLR service rate increase and/or MUSF support would present a "test year" revenue requirement calculation using the provider's financial results for its most recent fiscal year. According to TAM, its proposal reflects a natural (and necessary) consequence of the legislation enacted in 2012 deregulating all non-POLR services offered by ILECs. The TAM approach nonetheless bears some similarity to a traditional revenue requirement analysis and may be loosely characterized as an embedded cost approach to ratemaking because the foundation of the revenue requirements calculation is found in the company's financial books and records reflecting actual and historical revenues, expenses, and investment in plant. However, unlike a traditional embedded-cost proceeding, the truncated analysis as proposed by TAM would remove from scrutiny by the Commission (and the parties to the case) the operating efficiency of the utility. In other words, TAM would dispense with the process by which the Commission has traditionally considered whether and to what extent the "test year" results presented by the utility should be adjusted from the book results to more accurately reflect the financial results that would be generated by a "prudently" operated company. In addition, TAM also proposes to allow companies the flexibility to use estimates of future investment, expense, and revenue amounts. In traditional rate cases, these are called "known and measurable" adjustments.

TAM's proposal also abandons any attempt to separate rate base, expenses and revenues into regulated and unregulated categories. Further, no attempt is made to establish a distinct revenue requirement that is attributable solely to POLR service. Instead, all expenses and the return on all invested capital would be compared to all revenues regardless of whether those expenses, investment returns, and revenues relate to non-jurisdictional services or to unregulated – but jurisdictional – non-POLR service offerings. Finally, TAM's proposed revenue requirement methodology would rely upon a hypothetical cost of capital and capital structure assumed to be uniform across all telephone utilities – an assumption that may not be accurate and could lead to an incorrect revenue requirement and statement of earnings.

It is questionable whether TAM is correct that its proposal reflects the outer bounds of the Commission's remaining authority to conduct an embedded cost analysis particularly where the disbursement of consumer-funded MUSF subsidies are at issue. Nevertheless, the TAM proposal would plainly streamline and reduce the cost of conducting a rate case. However, these sought after procedural efficiencies may come at the cost of the accuracy that a traditional rigorous examination typically affords. One possible consequence of conducting a proceeding of the sort that TAM advocates would be that the results of the analysis would call for an increase in rates and/or MUSF disbursements when, in fact, the utility already earns a sufficient return and does not require any increase in revenues.

FairPoint proposes an altogether different method for setting POLR service rates and establishing the levels of MUSF support disbursements. Specifically, FairPoint advocates the adoption of a specialized, economic cost model that would, in theory, calculate the forward-looking cost of building and maintaining a modern telecommunications network that would be capable providing POLR service (and broadband services) in each of FairPoint's distinct exchanges throughout the State. One advantage of this approach would be the incorporation of geographic-specific data regarding the various costs of operating a network that is capable of providing POLR service. These figures would not be established by reference to historical costs actually incurred to build existing plant but, instead, would be developed by estimating what it would cost to build a new network, using existing technology, that is capable of offering POLR service. By disaggregating financial information to make it geographically specific, the FairPoint cost-model approach may be well tailored to an attempt to set the rates for POLR service in a particular geographic area at levels that have some relation to the actual costs of providing the service in that area.

FairPoint has engaged the services of a consultant, CostQuest Associates, to construct an economic forward-looking cost model. On December 17, 2012, FairPoint made the model available for inspection by the Commission and the stakeholders pursuant to a protective order. The underlying assumptions and formulas of the model, and the inputs FairPoint and CostQuest have used to run the model, have not been analyzed or tested as they would be in a future adjudicatory case before the Commission. Taking the model as produced by FairPoint at face value (i.e., assuming that the formulas and inputs are all appropriate, correct and complete), the results could be relied upon by FairPoint to justify a request for MUSF support at amounts that could cause the total size of the MUSF to grow from its current level of $8 million to more than $130 million[6]. According to the CostQuest model, the total revenues generated in 2011 by the FairPoint companies from the sale of local services (including ancillary services such as caller id, call waiting and call forwarding) was $123 million. Thus, under the model, FairPoint would receive $1.06 in MUSF subsidy for each dollar of local service revenue generated by the company throughout its service territory. Moreover, under the model run produced by FairPoint, for every $1.00 increase in POLR service rates approved for those exchanges that the company claims are not "profitable," the company's total "need" for MUSF support would be reduced by approximately $3 million. At 2011 local service rates, the model suggests that FairPoint might receive MUSF support in those exchanges where its revenues currently fall below its projected

[6] This figure does not include any additional amount of MUSF subsidies for the non-FairPoint companies under the TAM approach. TAM estimates that under its approach, the MUSF needs of the non-FairPoint companies alone will grow from $10 million in 2013 to $19 million in 2017 which, when combined with the results of the run of CostQuest model provided by FairPoint, suggests a total MUSF of approximately $149 million. TAM does not presently possess information which would allow data from the non-FairPoint carriers to be input into the CostQuest model.

forward-looking costs (“unprofitable” exchanges) in an amount of approximately $43 per line per month.

The size of the hypothecated MUSF fund may be due, in part, to the fact that the “cost” side of the model is an estimate of the cost to build a new, modern network designed chiefly to provide broadband service while the “revenue” figure inputs of the model are those associated with historical revenues achieved from selling POLR service and telephone services that were previously regulated. This “disconnect” between forward looking costs and historical revenues, and the different services that the costs support as compared to the services that the revenues reflect, highlights the inherent difficulty in relying solely upon a forward-looking cost model to establish POLR rates and MUSF subsidies. Indeed, one of the complexities of developing and applying a forward looking cost model is that no one could, or would, actually build a network today for the sole purpose of providing POLR service. Indeed, there was material submitted during the stakeholder process to the effect that building such an inferior network might well cost more than a broadband capable network because the component parts of a POLR only network are simply not available. Thus any forward looking model used to estimate “POLR support need” will inevitably overstate the need if only POLR revenues (rather than all revenues enabled by the new network) are used as an offset to the costs prior to calculating support.

With the recognition that the CostQuest model is something of a black box, and still requires thorough examination of the sort facilitated by an adjudicatory proceeding at the Commission we are able to offer generalized observations regarding the overall *concept* of using any cost model in establishing MUSF support levels. For example, a significant disadvantage of adopting a forward looking cost model approach is that such a model, by its very nature, does not produce as an output the amount of revenues that a firm requires. Consequently, to determine whether or not a carrier in fact requires an increase in POLR service rates and/or MUSF disbursements, it would be necessary to reconcile the cost-by-exchange results of the model with the company’s total revenue requirement. Thus, while a forward-looking model would provide information valuable for setting the rate for POLR service in any given geographic area, it would not provide information from which the Commission could readily determine whether increases in POLR service rates or MUSF support are warranted.

However, there do exist ways in which a forward-looking cost model could profitably be used as a tool in establishing MUSF support levels. For example, the cost model could be used to establish the cost of the network that is necessary to provide POLR service, and the amount of MUSF support that a POLR carrier receives would be equal to the difference between the modeled costs of the network and the modeled revenues generated from the services provided over that modeled network. Alternatively, the MUSF support level established by comparing modeled costs to modeled revenues could be capped. The level of the cap would be established through a separate "embedded cost revenue requirements" analysis.[7] Thus, the cap in MUSF support for a given POLR carrier would be the difference between the total embedded costs and the total revenues of the POLR carrier's existing (or "embedded") network. To the extent that the Legislature is inclined to select either one of these alternatives, the Commission believes that the addition of an embedded costs approach to a forward-looking cost model analysis is preferable because it will create an incentive for the POLR carrier to actually maintain and improve its network. Without the use of such a cap based upon embedded costs, a POLR carrier would receive MUSF support based solely on the hypothetical costs of building a new network regardless of the amount the costs that it incurs (or elects not to incur) to maintain and improve its existing plant.

Variants of this approach are both possible and merit consideration. For instance, a POLR carrier seeking MUSF support might be required to select the particular exchanges for which it seeks support. In this scenario, the forward looking cost model would establish the cost of building a modern network in that exchange that is capable of providing POLR service. Alternatively, a POLR carrier seeking MUSF support might be allowed to total the forward looking costs of its network in all of the exchanges in which it operates. The fundamental difference between these two scenarios is that under the second, "all exchanges" approach, there would be a continuation of existing implicit cross-subsidization of costs from low cost areas to high cost areas of the POLR carrier's territory. Regardless of whether implicit (hidden) cross-subsidies are viewed favorably from a policy perspective, the more granular, "exchange by exchange" approach (which can be performed with the outputs of a cost model) is, in the Commission's view, preferable. This is so because MUSF subsidization can be restricted to truly high cost, low profit exchanges of the POLR carrier's network. Moreover, by making MUSF disbursements on this basis, there exists an opportunity for the Commission to conduct a "reverse auction" through which the POLR carrier in a particular exchange could be replaced with a less expensive (in terms of monetary demands on the MUSF) carrier. The Commission's recommendation that it be authorized to conduct reverse auctions for alternative, less expensive, POLR carriers is explained in detail below. However, an auction methodology is only practical if MUSF support levels are determined on an exchange specific basis.

In sum, the Commission currently favors the following approach. A POLR carrier seeking MUSF support should be required to identify the particular exchanges for which support is necessary. A forward looking cost model will establish the costs of building a modern network in that exchange that is capable of providing POLR service. The "presumptive" amount of MUSF support will be the difference between the modeled costs of that network and the modeled revenues of that network, subject to both a cap on the total MUSF support level allowed for the POLR carrier and the possibility that an alternative POLR carrier will successfully bid to provide POLR service in that particular

[7] FairPoint opposes the imposition of such a cap on the amount of MUSF funding that may be disbursed to a POLR carrier, claiming that a embedded cost study used to establish a cap is a remnant of monopoly-era economic regulation which "assumes" that profits in low cost markets can be used to fund high cost markets.

exchange. The MUSF support cap for a particular POLR carrier will be the difference between the total embedded costs of its existing "state-wide" network and the total revenues generated by that existing "state-wide" network.

In adopting this recommendation, the Commission recognizes that the construction of a forward looking cost model may be burdensome to the TAM companies given their relatively small size even though representatives of CostQuest have stated that its model could easily be used by the smaller ILECs.   Consequently, the Commission is of the view that a traditional, but rigorous, embedded cost revenue requirement analysis may, in some instances, be more appropriate for these companies.

Although the Commission presently believes that this is the best approach for conducting revenue requirement and MUSF support proceedings for POLR carriers, we recommend that the Legislature refrain from statutorily mandating any particular approach. The Commission believes that it possesses the expertise with which to analyze any particular methodology that a POLR service provider may wish to advance in the context of an actual rate case, and that it possesses the institutional capacity to conduct adjudicatory proceedings in which the various complex issues that arise are subject to rigorous testing by both the Commission's staff and interested parties desiring to intervene in those proceedings. Stated more plainly, the Commission's tentative view that it has identified the best way to proceed could be proven incorrect, and the best place to test any given methodology is in the hearing room. It is particularly hard to make a definitive judgment at this point since the CostQuest model has not been examined and vetted by the stakeholders or the Commission staff.

B. A benchmark POLR service rate needs to be established prior to authorizing any MUSF support

Regardless of what method of establishing a POLR service provider's revenue requirement is found most effective (either by the Legislature or, as recommended, by the Commission in the context of an actual rate case initiated by a POLR service provider), a benchmark rate for POLR service will need to be established. Such a benchmark would be the maximum rate that consumers should be required to pay for POLR service.[8] Establishing such a benchmark is, by its nature, an exercise in judgment and discretion because it requires an evaluation of a wide variety of factors, including cost, market alternatives, and customers' expectations and willingness to pay. In the context of POLR service, the Commission continues to believe that it would be reasonable for the benchmark POLR service rate to be set according to the particular cost characteristics of discrete areas within a carrier's service territory, with the result that POLR service rates are likely to vary from area to area. Such "rate de-averaging"

[8] The Commission also expects that it will establish a minimum benchmark rate for POLR service in the course of a POLR rate case where the carrier seeks MUSF support. A minimum benchmark rate would ensure that a POLR carrier first looks to its customers for additional revenues before seeking MUSF support.

was a topic discussed at length in the Commission's Plan submitted to the Legislature in 2012. Regardless of whether de-averaging of POLR service rates is authorized by the Legislature, it may be advisable that the task of setting the POLR service benchmark rate be assigned to the Commission, perhaps constrained by a range of acceptable prices established by legislation. Given that current rates for basic local exchange service fall within a range of $22 to $25 (including federally mandated charges and MUSF fees), the Legislature may wish to consider a benchmark range of between $25 and $35. Again, the establishment of a benchmark rate, or range of acceptable benchmark rates, is fundamentally a policy judgment, and the Commission is prepared to provide information as required by the Legislature to inform its exercise of that judgment. In evaluating an appropriate benchmark rate or range of rates, it is useful to recall that, to the extent that rates are set at lower levels, the inevitable result will be a larger MUSF fund, however that fund is calculated. Moreover, requiring the ILECs to look to their own customers – by raising rates, winning back customers, or providing additional services – is more consistent with the situation of non-regulated firms, where, if a firm loses revenues through lost market share, it does not have the opportunity of "socializing" its losses through a fund collected from the customers of its competitors.

C. The Legislature should authorize a reverse auction process to assist in setting the level of MUSF support to be disbursed to a POLR service provider

Although the Commission's recommendations regarding the process that would be best for establishing POLR service rates are principally based on traditional principles (i.e., make sure that you don't hand out money without a strong showing that it is needed), we also recommend that, to reflect the emergence of competition in the telecommunications market in Maine and to take advantage of that emergence, a reverse auction be conducted for the right to receive MUSF support and the accompanying POLR service obligation.

Thus, after the revenue requirement and benchmark POLR service rate is established through a ratemaking proceeding, the petitioning ILEC could request MUSF support up to the level necessary to satisfy the difference between the established revenue requirement and the amount of revenue that the POLR service provider would expect to collect by charging the benchmark POLR service rate. Such a request for POLR service support, however, would not be automatically approved. Instead, an ILEC's request for a specific level of monetary MUSF support would be treated as a reserve "bid" price for supplying ubiquitous POLR service to those customers in a specified area (which might be the entire ILEC service territory) who desire to purchase such a service. The Commission would then conduct a "reverse auction" for MUSF support in which the ILEC and qualified competitors would have the opportunity to submit bids for the amount of MUSF support that they would require in exchange for assuming the obligation to provide POLR service, at no more than the established benchmark rate. The Commission would then evaluate the bids against the ILEC's MUSF support request and would award MUSF support to the lowest bidder, subject, of course, to a determination that the winning bidder has the operational and financial capability to offer POLR service to all customers within the area through either its own facilities or facilities that it is able to lease from other carriers. Among the prerequisites of a successful bid would be the demonstration by the bidder that it is able to provide POLR service, as that service is defined in 35-A M.R.S.A. § 7201(7) for the entire period in which it remains designated as the POLR service provider.

There are, we think, several advantages to this approach for the administration of the MUSF. An ILEC will have an incentive to be fiscally conservative in its request for MUSF support because if its request is artificially or unreasonably inflated, it will be more likely that a competitor would win the auction with a lower bid. Competition for MUSF funding would encourage the offering of POLR service by potentially lower-cost carriers, thereby reducing the overall size of the MUSF fund. If no competitor successfully bids on the opportunity to receive MUSF support in exchange for offering POLR service (or if there are no bidders at all), the support request of the ILEC would be granted at the level of the lower of the ILEC's bid or the result produced by the cost model – a level that would have already been established as reasonable in light of the preceding revenue requirement rate case. In addition, the use of a forward-looking cost model may be helpful in ensuring that the amount of approved support does not exceed the costs of providing POLR service projected by the model.

The Commission has successfully conducted auctions for standard offer electricity supply contracts ever since the deregulation of the electricity supply market in Maine. While the contours of a reverse auction for MUSF support are, of course, different from those of a standard offer bidding process, such a competitive, market-based approach to MUSF support for POLR service providers has a similar potential to advance the public policy of ensuring that POLR service is available to all Maine citizens while at the same time exerting a degree of fiscal constraint on the overall budget of the MUSF and the concurrent burdens placed on all Maine telecommunications consumers who are obligated to contribute to the fund.

In making this recommendation, we fully acknowledge that, if the ILEC is displaced as the POLR provider, and thus loses MUSF support, the underlying ILEC network – which now provides a variety of services, including services to its competitors presently mandated by federal law – might no longer be maintained as it is today or, indeed, might be abandoned altogether. While we do not view these as likely results, we believe that, if there is in fact an alternative provider of services that meet POLR standards and ubiquity, it is not at all clear what public purpose would be served by continuing to support a network that cannot support itself. It is in the nature of competition and technological change that, on occasion, structures, products and services that have served us well are left behind. We do not see that result as an objective of our proposal, nor as an inevitable or even likely consequence. But it is a possibility, and, if the carefully constrained circumstances for the removal of MUSF support from incumbents come to pass, we will seek to minimize the possibility that the loss of support for that network could compromise Maine's citizens' ability to obtain the telecommunications services they require.