

Overview of Penalty Mechanisms in Other States

Other New England states have used penalties in an effort to provide incentives for service quality maintenance and/or improvements for consumers in Verizon's ILEC territories that it recently sold to FairPoint Communications, Inc. ("FairPoint"). Vermont and Maine use similar systems to assign penalties to Verizon Vermont and Verizon Maine, respectively, in the event of service quality shortfalls. In both states, calculation of the penalty is based on the percentage deviation from the benchmark, summed over all benchmarks. For example, if the benchmark for Metric Alpha is 16, and the actual performance is 18, then the percentage deviation is $(18-16)/16$, or 12.5%. In almost every case in both states, the performance areas are measured monthly and averaged over 12 months, resulting in the annual performance measure. One difference between Vermont and Maine is how the percentage deviations are translated into actual dollar-amount penalties. In Vermont, the percentage deviations are converted to "points," with each point representing a specific dollar amount penalty. The penalty structure is such that as more points are accumulated (i.e. – service is worse), the points become more "expensive." In Maine, each percentage deviation "costs" the same amount - \$7,500. In both states, the total annual service quality refund is capped – at \$10,515,650 in Vermont, and at \$12,500,000 in Maine.

Vermont: In 2005, the Vermont Public Service Board ("PSB") adopted a new AFOR plan for Verizon Vermont in which it retained its Service Quality Plan.¹ Verizon Vermont had proposed to eliminate the plan, arguing that there was a sufficient degree of competition in the market to justify such a decision. The Vermont PSB found that:

Existing and future competition for local exchange service and other telecommunications services alone will not substitute for a regulated approach to retail service quality . . . The existence of competitive alternatives alone will not necessarily substitute for service quality standards. Moreover, Verizon's performance over the last five years belies its assertion that competition is sufficient to protect service quality. Competition has clearly increased during this period, yet Verizon's service quality performance deteriorated. Unless we accept the premise that consumers must accept lesser service quality in a competitive market, which we do not, we can only explain this dichotomy by inferring that competition does not provide adequate restraint . . . As the Department points out, most of the New England states have imposed a set of service quality standards that include predetermined penalties or customer credits for service quality failures. The Service Quality Plan that we adopt is consistent with these other programs. We conclude that Vermont's status as a relatively small part of Verizon's territory requires a service quality plan with significant penalty dollars attached in order to achieve its purpose of maintaining adequate service quality. Unless the plan contains a strong incentive for Verizon to keep its service quality high, there is too much risk that Verizon will not take steps to preserve service

¹/ *Investigation into a Successor Incentive Regulation Plan for Verizon New England Inc., d/b/a Verizon Vermont*, State of Vermont Public Service Board Docket No. 6959, *Order*, September 26, 2005.

quality and treat the payments as a cost of doing business.²

The Board also stated:

The need to ensure adequate service quality remains a fundamental public policy goal. Based upon our experience with the retail service quality plan adopted in Docket 6167 and the penalty payments resulting from service quality failures under that plan, a retail service quality plan with penalty provisions is the best method of insuring an adequate level of service quality while at the same time ensuring that customers are compensated for the failure to receive the service quality they should expect. Experience has shown that, even when penalties exist, Verizon failed to comply with a service quality plan that it recommended after negotiating the plan with the Department; it is hard to envision that Verizon would have maintained service quality would be maintained at pre-existing levels in the absence of such penalties.³

The Board further stated:

The 2000 Service Quality Plan agreed to by the parties and adopted by the Board in Docket 6167 included a \$10.5 million annual cap on the amount of service quality penalties. The 2005 Service Quality Plan adopted in this Order maintains the \$10.5 million penalty cap. In its Comments on our Proposed Order, Verizon argues that in maintaining the cap amount, the Board has failed to address its arguments regarding the increasingly punitive nature of the cap. Verizon believes that cap should be adjusted to reflect its declining revenues and earnings. Verizon states that its Proposed Findings demonstrate that, due to declining revenues since 2000, the percentage of its earnings at risk under the 2000 Service Quality Plan has grown significantly. Verizon argues that these findings were undisputed and not addressed by the Board in its Proposed Order. Further, Verizon argues that the Board has failed to identify any evidence that supports the reasonableness of maintaining what it describes as a “draconian penalty level.”

We are unpersuaded by Verizon's arguments. The Proposed Findings cited by Verizon, state that the service penalty cap is unreasonable “as compared with other New England states.” and in “other jurisdictions” We note that Verizon has not submitted a retail service quality plan with penalty dollars cap amounts commensurate with its lower revenues as in other New England states. In fact, Verizon argued that a retail service quality plan was no longer necessary due to increased competition levels and that if the Board felt a plan was necessary, it should contain no monetary penalties.

Moreover, Verizon’s arguments concerning the size of the penalty cap amount were squarely addressed in the Proposed Order. We concluded that the 2005 Service Quality Plan is consistent with other states' service quality plans because

²/ *Id.*, at 130-131.

³ *Id.*, at 103-104.

these programs have also “imposed a set of service quality standards that include predetermined penalties . . . for service quality failures.” We also found that it was necessary for Vermont to maintain a relatively high penalty provision to ensure high service quality “in a relatively small part of Verizon's service territory” such as Vermont.” We concluded that “[u]nless the plan contains a strong incentive for Verizon to keep its service quality high, there is too much risk that Verizon will not take steps to preserve service quality and treat the payments as a cost of doing business.” In addition, the Department presented evidence in support of maintaining the existing penalty amounts, which we found persuasive. Therefore, we see no reason to modify the penalty cap amount of the 2005 Retail Service Quality Plan.

Finally, the debate over the size of the potential penalty amount masks the underlying goal of the service quality standards. It is the Board’s strong preference that Verizon pay *no* penalty. We established these standards in 2000 and continue them now to encourage Verizon to maintain the high service quality that it had in place before the onset of incentive regulation. Verizon has shown that it can attain these standards if it chooses to deploy adequate facilities and staff. Verizon itself agreed in 2000 that these were reasonable. Large penalties only exist when Verizon fails to meet its performance expectations. Considering the availability of a waiver for unforeseeable events, this would only occur as a result of choices that Verizon itself made. Verizon has shown no reason why the risks of these choices should be removed from Verizon and passed on to its customers⁴

Verizon Vermont’s Service Quality Plan calculates points based on the failure of Verizon VT to meet approved metrics on a monthly basis. These points are translated into dollar amounts to assess a penalty on Verizon Vermont. The penalty is then distributed to customers and on a yearly basis in the form of a one-time rebate, or “Service Quality Compensation.”⁵ The total penalty, or compensation, is capped at \$10,515,650.⁶ In 2008, the Vermont Public Service Board approved the sale of Verizon’s operations in Vermont to FairPoint Communications, Inc. FairPoint continues to operate under the same service quality standards and compensation penalties as well as an additional performance enhancement plan to address network deterioration that occurred before FairPoint bought the operations.⁷

The financial consequences would not apply if Verizon MA achieves those service quality

⁴ Id., at 153-155.

⁵ / Id., at Appendix C.

⁶ / Id.

⁷ / *Joint Petition of Verizon New England Inc., d/b/a Verizon Vermont, certain affiliates thereof, and FairPoint Communications, Inc. for approval of an asset transfer, acquisition of control by merger and associated transactions*, Vermont PSB Docket No. 7270, Order entered February 15, 2008, at 20-26; *Joint Petition of Verizon New England Inc., d/b/a Verizon Vermont, certain affiliates thereof, and FairPoint Communications, Inc. for approval of an asset transfer, acquisition of control by merger and associated transactions*, Vermont PSB Docket No. 7270, Order entered December 21, 2007, at 105.

standards deemed appropriate by the Department. Yet, by establishing such financial consequences, a safeguard could prevent a decline in the future. To the extent that competitive pressures discipline a local service provider's service quality, the financial consequences would be irrelevant (or nonbinding). In other words, if Verizon MA is correct that competitive pressures are sufficient to result in the provision of quality service at a reasonable price then Verizon MA can meet service quality standards and will not be required to pay penalties for poor service

Maine: The current Service Quality Index in Maine, applicable to FairPoint, is largely based on Verizon's AFOR, first adopted in 2001 and again in 2005, and includes a rebate mechanism similar to Vermont's.

We agree with the reasoning behind the OPA's recommendation to increase the maximum customer rebate amount in the revised SQI, and we will increase it, but not to 4.5% of Verizon Maine's 2000 jurisdictional revenues, as the OPA recommends. For the original SQI we had set the maximum rebate amount, \$11 million, at approximately 3.4% of Verizon Maine's 1995 revenues. We will apply that same percentage to the Company's 2000 revenues, which results in a maximum customer rebate of \$12.5M, a 13.5% increase above the current maximum. We will also increase the maximum per-metric rebate amount by the same percentage, from \$1M to \$1.135M, and from \$2M to \$2.27M for the Service Outage metric.⁸

Despite granting pricing flexibility for many of Verizon Maine's retail services, the Maine Public Utilities Commission ("PUC") retained Verizon Maine's Service Quality Index ("SQI") in 2005 and, in fact, increased the total number of indices and the amount of the potential penalty faced by the company.⁹ The PUC found that precisely because Verizon Maine had gained a reduction in regulation, the SQI should be retained.¹⁰

On February 1, 2008, the Maine Public Utilities Commission issued an Order Approving an Amended Stipulation in Dockets 2007-67 and 2005-155 that approved the sale of Verizon New England Inc., d/b/a/ Verizon Maine (Verizon) to FairPoint Communications, Inc. (FairPoint).¹¹

⁸ / Investigation into Verizon Maine's Alternative Form of Regulation, Maine PUC Docket No. 99-851, Order (Part 2), June 25, 2001, at 42.

⁹ / *Maine Public Utilities Commission Investigation into Bell Atlantic-Maine's Alternative Form of Regulation*, State of Maine Public Utilities Commission Docket No. 99-851, Order (Part 1), May 9, 2001.

¹⁰ / *Maine Public Utilities Commission Investigation into Bell Atlantic-Maine's Alternative Form of Regulation*, State of Maine Public Utilities Commission Docket No. 99-851, Order (Part 2), June 25, 2001, at 39.

¹¹ / *Verizon New England Inc., Northern New England Telephone Operations Inc., Enhanced Communications of Northern New England Inc., Northland Telephone Company of Maine, Inc., Sidney Telephone Company, Standish Telephone Company, China Telephone Company, Maine Telephone Company, and Community Service Telephone Co., Re: Joint Application for Approvals Related to Verizon's Transfer of Property and Customer Relations to Company to be Merged with and into FairPoint Communications, Inc.*, Maine Public Utilities Commission Docket No. 2007-67; *Investigation into Verizon Maine's Alternative Form of Regulation*, Maine Public Utilities Commission Docket No. 2005-155, Order, February 1, 2008. The Amended Stipulation was entered into by

The Order largely left the service quality regime that had been in place intact. FairPoint must comply with the prevailing Service Quality Index (“SQI”) procedures and is subject to penalties. The rules are based on the Verizon’s prior alternative plan of regulation adopted in 2001 and 2005 and the Amended Stipulation. The Amended Stipulation, approved by the Maine Public Utilities Commission in its investigation of the sale of Verizon’s local exchange business to FairPoint, increases the penalties for failure to meet service quality benchmarks in multiple years. “If FairPoint has failed to achieve its performance benchmark for a given metric in two or more consecutive years, beginning after July 1, 2008, the SQI penalty for that metric shall be the base penalty for that metric multiplied by a multiplier equal to the number of consecutive years that penalty has been missed.”¹² However, the maximum annual penalty for all benchmarks remains \$12.5 million. The Maine PUC concluded that: “The enhanced SQI metric will ensure that Maine people get the services they deserve and the risk of increased penalties will help to guarantee it.”¹³

In addition to the \$12.5 million maximum, there is a maximum of \$1.135 million for each metric except for the Service Outage metric which is subject to a \$2.27 million maximum.¹⁴

New Hampshire:

In New Hampshire, the Public Utilities Commission approved a settlement agreement as part of its approval of the sale of Verizon’s local exchange business to FairPoint in February 2008.¹⁵

FairPoint, The Office of Public Advocate, the Commission’s Advocacy Staff, Biddeford Internet Corp. d/b/a Great Works Internet (GWI), Cornerstone Communications, LLC (Cornerstone), and the AARP filed with the Commission December 21, 2007 and amended January 3, 2008. The Stipulation was further amended with the addition of “Commission-imposed conditions.” *Id.*, at 2.

¹² / *Investigation into Verizon Maine’s Alternative Form of Regulation*, Maine Public Utilities Commission Docket No. 2005-155; *Compliance with Commission Order dated 2/1/08 in Docket No. 2005-155*, Maine Public Utilities Commission Docket No. 2008-209, *Procedural Order – SQI Calculations*, May 9, 2008, citing Amended Stipulation, Attachment 1, para. 3. A new metric was also added to the SQI: Duration of Residential Outages. The metric is based on FCC ARMIS data. *Id.*, at 3.

¹³ / *Verizon New England Inc., Northern New England Telephone Operations Inc., Enhanced Communications of Northern New England Inc., Northland Telephone Company of Maine, Inc., Sidney Telephone Company, Standish Telephone Company, China Telephone Company, Maine Telephone Company, and Community Service Telephone Co., Re: Joint Application for Approvals Related to Verizon’s Transfer of Property and Customer Relations to Company to be Merged with and into FairPoint Communications, Inc.*, Maine Public Utilities Commission Docket No. 2007-67; *Investigation into Verizon Maine’s Alternative Form of Regulation*, Maine Public Utilities Commission Docket No. 2005-155, *Order*, February 1, 2008, at 40.

¹⁴ *Investigation into Verizon Maine’s Alternative Form of Regulation*, Maine Public Utilities Commission Docket No. 2005-155; *Compliance with Commission Order dated 2/1/08 in Docket No. 2005-155*, Maine Public Utilities Commission Docket No. 2008-209, *Procedural Order – SQI Calculations*, May 9, 2008, at 7.

¹⁵ / *Verizon New England, Inc., Bell Atlantic Communications, Inc., NYNEX Long Distance Co., Verizon Select Services, Inc. and FairPoint Communications, Inc. Petition for Authority to Transfer Assets and Franchise, Order Approving Settlement Agreement with Conditions*, New Hampshire Public Utilities Commission Docket No. 07-011, *Order No. 24,823*, February 25, 2008 (“NH PUC Verizon – FairPoint Order”). Joint Petitioners (Verizon and FairPoint) and the NH PUC Staff filed a settlement agreement on January 24, 2008. NH PUC Verizon-FairPoint Order, at 16. Hearings and two technical sessions took place to examine the agreement. *Id.*, at 17.

The penalties associated with the new service quality standards approved by the PUC are modeled on the Maine service quality penalty structure, according to the settlement agreement. The penalties are \$7,500 per percentage point missed subject to an overall annual limit of \$12.5 million.¹⁶

Connecticut

The Connecticut Department of Public Utility Control (“DPUC”) adopted SNET’s original alternative regulation plan in March of 1996 in Docket No. 95-03-01.¹⁷ On May 16, 2001 the Department extended SNET’s alternative regulation plan, with a few modifications.¹⁸ However, the Department found that the generic standards it adopted for SNET and other carriers were less stringent than the prior plan standards for SNET and thus increased the penalties for failure to meet the new standards.¹⁹ In 2006 when the Department investigated issues regarding the company’s reserve deficiency it found that: “No evidence exists that suggests that the Alt Reg. Plan is not satisfying the basic statutory tests prescribed by Conn. Gen. Stat. §16-247k(b)” and kept the plan in place until further review.²⁰

In 2006, the Connecticut state legislature enacted Public Act 06-144, amending Conn. Gen. Stat. § 16-247(f) to effectively make almost all of AT&T’s services competitive.²¹ As a result, nearly all of AT&T’s services are not subject to the Price Cap plan (as it only applies to non-competitive services).²²

As noted above, in 2001 the Department determined that the Q factor would be applied to

¹⁶ / Settlement Agreement, Exhibit 3: FairPoint Retail Quality of Service Commitments, at 4.

¹⁷ / Prior to that time, SNET was rate-base regulated. *DPUC Investigation of the Southern New England Telephone Company’s Alternative Regulation Plan*, Connecticut Department of Public Utility Control Docket No. 00-07-17, *Decision*, May 16, 2001, at 1-2, citing Docket No. 95-03-01: *Application of Southern New England Telephone Company for Financial Review and Proposed Framework for Alternative Regulation*.

¹⁸ / *DPUC Investigation of the Southern New England Telephone Company’s Alternative Regulation Plan*, Connecticut Department of Public Utility Control Docket No. 00-07-17, *Decision*, May 16, 2001, at 1. The DPUC states in the Conclusion to the decision, however, that the Alt Reg Plan will continue “until the plan is terminated in another proceeding.” *Id.*, at 37.

¹⁹ / *DPUC Investigation of the Southern New England Telephone Company’s Alternative Regulation Plan*, Connecticut Department of Public Utility Control Docket No. 00-07-17, *Decision*, May 16, 2001, at 31. The plan’s penalties were implemented through a Q factor in the price cap formula, with the exception of residential service. For residential service, the Department had previously determined that reductions in residential rates below TSLRIC was “inappropriate and unlawful” and, as such, the Department, in the 2001 Decision, adopted customer bill credits in the event that the company failed to meet objectives for any five months within a rolling twelve month period. *Id.*

²⁰ / *DPUC Review of the Southern New England Telephone Company’s Reserve Deficiency*, Connecticut Department of Public Utility Control Docket No. 03-01-11, *Decision*, February 1, 2006, at 11.

²¹ / Conn. Gen. Stat. § 16-247f(b), effective July 1, 2006.

²² / Competitive services are not subject to price cap regulation. See, e.g., Conn. Gen. Stat. § 16-247k. See, also, *Application of Southern New England Telephone Company for Financial Review and Proposed Framework for Alternative Regulation*, Connecticut Department of Utility Control Docket No. 95-03-01, 2008 Annual Price Cap Filing of the Southern New England Telephone Company, May 1, 2008, at 2.

residential service for a failure to meet retail service quality standards any five months within a rolling twelve month period. According to its 2008 Annual Price Cap Filing, between April 1, 2007 and March 31, 2008, AT&T missed Out of Service Repair standards in five or more months and that standard is associated with a 0.2% Q-factor penalty.²³ Thus, the non-competitive local residential service revenues (from May 1, 2007 through April 30, 2008) are multiplied by the 0.2% Q-factor for a penalty of \$8,363.23.²⁴

The penalty is not large enough to provide a financial incentive to improve service quality. For example, AT&T claimed exogenous costs amounting to \$118,365.80 for the same period. AT&T states in its 2008 Annual Price Cap Filing: "While AT&T is entitled to recover all its exogenous costs from customers, AT&T, as a gesture of good will to its customers, will not seek to otherwise recover these exogenous costs."²⁵ A penalty must be large enough that the company would rather work to provide better service quality than pay the penalty.

"Additionally, the Department has determined that with respect to Local Residential Service the Q factor will not be incorporated as a component of the general ratemaking formula originally adopted in the original Alt Reg Plan. The Department has in the past concluded that decreasing the rates of services priced below TSLRIC is inappropriate and unlawful. Decision dated June 25, 1997, Docket No. 95-03-01, p. 5. Instead, in order for Local Residential Service customers to be properly compensated for any deficient quality of retail service provided by the Telco, the Department herein removes the Q factor, with respect to Local Residential Service only, from the Telco's ratemaking formula and will assign it to an annual crediting methodology. Under this modification, any failure to meet the retail quality of service objectives for residential retail service for any five months within a rolling twelve-month period will result in a one-time monetary credit on residential retail customers' bills, rather than a recurring decrease in rates for any Telco-provided service(s). The amount of the credit will be computed by multiplying Local Residential Service revenues by the Q factor penalty, and will be equal to 0.2% times the number of service standard objectives that the Telco failed to meet. The penalty will be calculated based on the cumulative amount of any retail residential quality of service violation that occurred during the period covered in the Telco's April price cap filing and will be credited on retail residential customers bills as soon as practicable after Department approval of the price cap filing but not later than 120 days."²⁶

²³ / *DPUC Investigation of the Southern New England Telephone Company's Alternative Regulation Plan*, Connecticut Department of Public Utility Control Docket No. 00-07-17, *Decision*, May 16, 2001, at 31.

²⁴ / *Application of Southern New England Telephone Company for Financial Review and Proposed Framework for Alternative Regulation*, Connecticut Department of Utility Control Docket No. 95-03-01, 2008 Annual Price Cap Filing of the Southern New England Telephone Company, May 1, 2008, at 4.

²⁵ / *Id.*, at 5.

²⁶ / *DPUC Investigation of the Southern New England Telephone Company's Alternative Regulation Plan*, Connecticut Department of Public Utility Control Docket No. 00-07-17, *Decision*, May 16, 2001, at 31.