a lot of states that legislatures don't meet very often, or for short periods. So it's not as easy as saying start a fund.

So maybe you can tell me how you read the Act differently, how you read it like somehow it suddenly shifts to be a state responsibility first, and then we add in the federal.

MR. WELCH: I don't view the Act as providing the level of specificity, or a level of specificity that would preclude the sort of thing that the ad hoc proposal is proposing.

I think that any interpretation of the Act has to take into account some level of practical, practicality. And I think a reading that suggests that you fund every high-cost line in the country directly out of a federal fund, which seems to be the interpretation that some might choose, would result in a couple of things.

First, it would invade a traditional area of state responsibility to a degree that I think many State Commissions would abhor. And second, it would create both an unwieldy and oversized structure that, frankly, isn't necessary to achieve the objectives of the Act.

So I think you could fairly read the Act as saying, yes, there ought to be a federal fund. And it ought to be sufficient. And I think what we have proposed in the ad hoc proposal would be sufficient, given the fact that there are states out there, and they do have resources, and they do have commissions, and they do have the ability to balance, as they have in the past.

So I don't -- I'm sorry.

MS. TRISTANI: Commmissioner Welch, if I could interrupt. Do you think -- I come from a state, but not all states are positioned the same. And some have more resources than others. And my concern is, I have every confidence that every state, if it could, might be able to do this. But my worry is that some states may not be in the position to be able to take care of. And my concern is that people will start falling off the network if we don't get this right.

MR. WELCH: Well, is it a concern that they won't have these sort of technical resources to do it, or that they won't have the financial resources?

MS. TRISTANI: Both. And also may not have the political resources, in some senses, to get it done in time.

MR. WELCH: Well, I think, if I might answer that. The ad hoc plan doesn't -- if you assume that we are starting today from a situation where service is generally affordable, states, they would not lose support under the ad hoc plan, because of the hold-harmless provisions. So that they would be no worse off than they are today, with respect to being able to take care of their citizens and their affordability needs.

And that's entirely consistent with the size of the fund and the approach of the fund that we are describing. So I think, if service now is generally ubiquitous, there is a level of support that is generally available. I think, as competition emerges and as subsidies are made more explicit, there will be some work to be done for the states.

But I think that's work that the states ought to welcome. And I honestly can't think of a state that would not have within its capabilities the ability to do the kind of making things explicit that this plan would require. And parenthetically, there are a variety of ways of making subsidies explicit, and deaveraging costs, without deaveraging rates. And those are two very separate things.

So the political objections to massive deaveraging of basic rates can be overcome simply by not doing it, even within a context of making the subsidies entirely transparent and explicit.

MS. TRISTANI: Commissioner Welch, by the way, I really am grateful for the work that you have done on this.

MR. WELCH: Thank you.

MS. TRISTANI: And for the work that your staff has done on this. I think it's really important to discuss your plan.

But I have not looked at it in detail. And I'm going to do what lawyers never should do, which is ask questions they don't know the answers to. And actually, I've been doing that already.

But did the plan take into account all the states? I mean, did you look at all the states? And also territories of the United States that are supported or receive support from the universal service fund.

MR. WELCH: The plan could do that, conceptually. We did not model the territories, nor, I think, Alaska, simply because we didn't have the data at the time. But there is nothing conceptually, and it wouldn't change the overall numbers very much to do that.

MS. TRISTANI: Okay. Mr. Chairman, that's what I have, I think.

MR. KENNARD: Thank you. In the interest of time, I will keep my questioning short.

First, I want to echo the comments of my colleagues here to commend you, Chairman Welch, for all the work that you put into the ad hoc plan. I think that you have considerably advanced the discussion, and focused attention on some very important issues. And I think that we are all very grateful to you for that.

In my view, as I stated in my opening remarks, the

Telecommunications Act is fundamentally about preserving and advancing universal service. And doing so in a new competitive paradigm for the marketplace.

And it seems to me that we cannot have full broad-based competition until we make these subsidies explicit. To that extent, I have to take issue with what you were saying, Mr. McLean, that you can have implicit subsidies in an era of competition. Because it seems to me that for a universal service system to be competitively neutral, we have to have explicit subsidies that are portable, that can be competed for. So that we can have universal service and competition.

And it seems to me that this is an obligation that falls both on the federal jurisdiction and the state jurisdiction. That is, to reform universal service in a manner that makes these subsidies supports explicit.

One of the issues with the ad hoc plan that I'm very interested in exploring is, how will this plan create incentives for the state jurisdictions to reform their universal service structures so that they are explicit? I guess you will have to take that one, Chairman Welch.

MR. WELCH: There are a number of ways of doing it, some of which are not yet incorporated into the plan.

I think first, as states open their own markets to competition -- and as a matter of fact, or not as a matter of law, the states are very interested in moving towards a competitive paradigm -- I think the states are recognizing that they need to make those subsidies explicit and portable for the reasons that Commissioner Powell elicited. So I think that's one thing, that it is very likely to happen, no matter what external incentives are built in.

There is a second provision, which is, my NARUC brethren may not be too happy about me mentioning this, but there is Section 253. That if states have not done what is necessary to open their markets, there is the ability of competitors to come to this Commission and seek to enforce the Act. And frankly, I think the failure to make subsidies sufficiently explicit to permit fair competition would be a trigger for that kind of proceeding.

And I think, third, it would be appropriate for this Commission to ensure, as times goes by, that perhaps through the mechanism of defeasance, that if the, if a state has not reached certain objectives by a certain period of time, then the question of whether or not that state should continue to receive any federal support ought to be reexamined.

So I think there are things that this Commission could do without inserting itself too dramatically into state, specific state rate structure issues, that would ensure that a sufficient level of explicitness was achieved in the state universal service mechanisms.

MR. KENNARD: Just so I understand clearly what you just said. You would accept, then, a notion that we could have a transitional mechanism which would, at some point in time, condition additional federal support on the states having achieved reform of their state structures.

MR. WELCH: Yeah. There is a little bit of a timing issue that is worth discussing.

I think that it's important to get a good mechanism in place now. And I think if the condition were that the state has to meet some particularized standard before anything happens would be problematic.

On the other hand, if the Commission were to say that in order to continue to receive support after two or three years, it had to have met certain objectives. So I think that would be entirely appropriate.

MR. KENNARD: So you think two to three years would be an acceptable period of time?

MR. WELCH: I believe so.

MR. KENNARD: Okay. Thank you.

MR. HAGEN: I agree.

MS. JOHNSON: I agree.

MR. KENNARD: Is it unanimous?

(Laughter.)

MR. MCLEAN: I think the states can speak for themselves on that question.

MR. KENNARD: Fair enough. Just a couple more questions for Chairman Welch.

You stated in your written testimony that your plan would result in a modest increase in the overall funding level for the high-cost fund. Can you give us a ballpark estimate of how big an increase you are talking about?

MR. WELCH: Our model suggests in the range of six to seven hundred million dollars. And I will throw in the following caveat. As the modeling has continued over time, and as the high-cost models continue to be refined, that number tends to shrink. It has never grown from one model to the next. We continue to find anomalies, particularly in the forward-looking cost area. So my expectation is that that is the outside.

MR. KENNARD: And I understand that under your plan, you would implement this so that rural carriers and non-rural carriers alike would be subject to the plan at the same time. Is that correct?

MR. WELCH: That is correct.

MR. KENNARD: Okay. So this would be a departure from the Commission's May 7 order, which called for a deferral of the rural companies.

MR. WELCH: In that respect, it would be.

Although the hold-harmless provisions, as a practical matter, take them back out.

MR. KENNARD: Yes.

MR. WELCH: So I think the concerns that the Commission expressed and why it had made the split initially are addressed through that provision of the plan.

MR. KENNARD: Well, thank you all. It's been very helpful. I appreciate your coming here and for your fine presentations. It was great. Thank you.

We will reconvene in about five minutes.

(Whereupon, a short recess was taken.)

MR. KENNARD: Okay. Without further delay --

MR. LUBIN: -- on state jurisdictions, I want to comment briefly on what I believe is the overriding issue before the FCC and state regulators that they must confront.

The level of all universal service support subsidies, whether for high-cost, low-income, schools, libraries, rural health care, must be kept to appropriate levels to reduce the impact of the program on consumers' telecommunications bills.

If regulators are unable to contain these subsidies within acceptable levels, the programs will suffer because of lack of public support.

Currently, the size of the universal service is forecasted to be about 4.9 billion, assuming that the existing high-cost component remains unchanged. And if, as expected, the collection rate for schools, libraries, and rural health care programs is increased to the 2.65 billion annual number.

In addition, the overall size of the fund could increase again come January 1, 1999, as we move to implement a proxy model-based approach for determining the high cost for non-rural local exchange carriers.

The ultimate size of the fund should be a concern for all of us, for two reasons. One, the size of the fund will impact telecommunications service prices paid by all consumers. And two, the long-distance carriers and their customers are paying about 93 percent of the local exchange carriers' obligations, in addition to their own. This is not competitive neutrality.

The ultimate size of the federal fund will be a function of several things. The 25/75 percent factor, the proxy model selected, the level of geographic area disaggregation used to identify the need for the high-cost support.

Frankly, the 25/75 federal/state split, while an important issue, is just one of many critical issues that must be addressed to keep the universal service program no larger than necessary, properly targeted, and manageable. Given the proxy model approach, AT&T believes that a new federal fund, premised on providing 25-percent support on interstate revenues versus 100-percent support on combined revenues, is preferable, because it gives the states appropriate flexibility to have their own funds, and avoids preemption and federal/state jurisdictional disagreements.

The 25/75 percent issue will be less of a concern if the size of all funds are established at appropriate levels. Let me explain what I mean.

The FCC's high-cost support mechanism was based on the fundamental premise that local exchange competition and the substantial erosion of the most profitable segment of the incumbent's customer base would necessitate a system of explicit support to maintain affordable rates. Unfortunately, the major incumbent, LEC -- namely, the RBOCs, GTE, and SNET -- have repudiated the compromise struck by the 1996 Act. They have made it clear that they want all of the benefits, including the new revenue streams from universal service assessment, which are ultimately borne by end users, and in the case of the RBOCs from entry into the long-distance market.

At the same time, they are unwilling to assume the burdens, including the obligation to open markets to their competitors through the provision of unbundled network elements and other means, or to reduce access charges.

The current FCC approach to high-cost support, which includes the determination of support on a wire center or other disaggregated level, plays into the major ILEC strategy by promising substantial new payments labelled as subsidies, while permitting them to keep 100 percent of the profits they collect in non-high-cost areas. Major ILECs simply have no need for such subsidies without creating the real opportunity for local exchange competition.

The telecommunications service revenues measured at the study area level are more than sufficient today to cover the costs, even without taking access contributions into effect, into account. Accordingly, AT&T now urges the Commission to delay the transition to the proxy methodology for determining high-cost support for major LECs, which is scheduled to begin in January, 1999, at the very least until these companies have opened their markets to robust and widespread competition.

If the Commission nonetheless proceeds with a proxy methodology, despite the absence of local competition, it should use study area level disaggregation to determine the subsidy for all LECs.

Final point on that is currently, today, there are 25 states that only have one zone for unbundled network elements.

Finally, the federal high-cost funding requirement anticipated for the year 1998 is about 1.7 billion. This includes the current high-cost fund, DEM weighting and LTS. That should continue, with the exception that the existing 114 million for high-cost for large LECs, major LECs, should be withheld.

Thank you very much.

MR. KENNARD: Thank you, Mr. Lubin. Mr. Smiley.

MR. SMILEY: Good morning, Mr. Chairman and Commissioners. My name is Jim Smiley. I am Regional Vice President for US West, with responsibility for four western and midwestern states. I have been involved with universal service both in and outside the beltway, and I can tell you, the further you get from Washington, the more real and difficult the problems of universal service become.

I would like to commend you, Mr. Chairman, for taking the time recently to travel to North Dakota to see and hear firsthand the unique universal service issues that we face in the west. Our territory is a land of extremes. And while the monthly cost to serve customers in downtown Fargo is in the $20 range, the average cost to serve customers in our Wyndemere, North Dakota exchange is $170 a month. And there are even further examples, as Mr. Hagen mentioned earlier.

In fact, in our 14-state territory, US West has over a quarter of a million customers -- a quarter of a million customers -- who cost in excess of $100 a month to serve.

In spite of these extremes, US West customers receive almost no support today from the universal service fund. And how can this be? Well, the reason is simple. Customers in Fargo subsidize customers in Wyndemere. Business customers subsidize residence customers. And intralata toll and access services subsidize basic resident service.

Congress, we believe, correctly recognized that this implicit support was not sustainable in a competitive marketplace, and called for a system of specific, predictable, and sufficient explicit support to be developed by this Commission.

US West believes that the proposed 75/25 plan does not meet this requirement. And we are not alone in this belief.

Attachment one to my exhibit summarizes what others are saying. Members of Congress from all 14 of the states in which US West operates have written, pointing out that the shortcomings of the 75/25 plan and calling for a national commitment to universal service.

Public utility commissions, state legislators, economic development organizations, and other representatives of rural America have spoken loud and clear about the need for a comprehensive national plan.

When you file your report to Congress in April, you must address these concerns. Otherwise we will be faced with a system of information haves and have-nots, based solely on where people live and the size of the telephone company that serves them.

Mr. Chairman, in your speech to NASUCA last month you suggested that all implicit support currently in the intrastate rate structures must remain within each state. The chart and the words that Mr. Hagen used earlier clearly illustrate the wide disparity that this would create.

There have been other suggestions about how to address this problem. The ad hoc NARUC plan would base funding on statewide averages of costs. A 100-percent national fund, in our mind, clearly the best solution, faces the problem that low-cost states may seek a court challenge that would delay much-needed explicit funding. And we absolutely, positively cannot delay the new fund beyond 1/1/99.

To form an equitable and workable plan, some way must be found to lighten the load on the states with the most extreme situations. To address this need, US West today is proposing an alternative plan that assigns all customer costs above a higher superbenchmark to the interstate fund, leaving the remaining universal service costs for recovery under the 75/25 formula. This has been referred to as the 30/50 plan in previous conversations.

When these super-high costs are removed from the intrastate equation, the extreme differences between states are greatly reduced. And we believe that the states can then solve the remaining problems themselves. Our specific proposal is summarized in my exhibit.

Congress directed the FCC to develop a plan to ensure the provision of affordable service in all regions of the nation. It is universal service. And we believe that our proposal can accomplish this goal. US West would be pleased to work with you and your staffs to further develop such a middle-ground plan.

Thank you. I look forward to your questions.

MR. KENNARD: Thank you, Mr. Smiley. Mr. Griffin.

MR. GRIFFIN: Thank you. I'm Haynes Griffin, Chairman of Vanguard Cellular. Thank you very much for inviting me to speak at this En Banc hearing on behalf of Vanguard.

Vanguard is a large independent cellular provider, and provides service to more than 685,000 customers in 29 markets in the eastern part of the US.

As you know, Vanguard has been an active participant in the Commission's universal service proceedings. I have been asked to speak today about Vanguard's position on the allocation of universal service funding between the FCC and state regulators. At the outset, I should note that Vanguard, like many other providers of wireless service, believes that commercial mobile radio services are subject only to FCC universal service funding requirements, not to state requirements.

No matter how that question is resolved, however, the allocation of financial responsibility for universal service between the federal and state jurisdictions is important. The FCC and the states should focus on the fundamental purposes of the new universal service requirements in Section 254. These purposes do not include shifting funding responsibility to the federal level.

There is also no evidence at this time that there is any need to create new subsidies at the federal level for what are now intrastate costs. Section 254, together with amendments to Section 214, creates a new universal service regime. There are there key elements to this regime, one of which the funding for schools, libraries and rural health care is outside the scope of today's discussion.

The second element of the new universal service regime is expanding eligibility for universal service funding so all competitors have an equal incentive to serve all subscribers. Vanguard, which serves a significant rural population in many of its service areas, expects that this element of the universal service program will give it the opportunity to meet the basic communications needs of many customers who are now underserved.

The third important element of the new regime is that it replaces the old system of implicit subsidies with explicit subsidies. Eliminating the implicit subsidies removes an important barrier to fair competition.

One thing, however, the new regime does not do is to require the FCC to create new subsidies for basic telephone service, or to provide subsidies at the federal level for intrastate services. There is nothing at all in section 254 that suggests, let alone requires, that the FCC change the current balance between federal and state recovery of the costs of providing telephone service.

I'd like to turn now to the effects of maintaining the current balance between federal and state recovery of the costs of providing telephone service. As the Commission has recognized, the key regulatory issue in both federal and state universal service proceedings is how to recover the costs of providing telephone service.

Historically, interstate revenues have been targeted to recover approximately 25 percent of the total costs of providing land-line service, and intrastate revenues have been targeted to recover the rest of these costs.

While some carriers actually recover more than 25 percent of their costs from interstate sources, 25 percent is a reasonably accurate approximation of the cost assigned to the interstate jurisdiction.

As a practical matter, however, there is little evidence that 25 percent actually represents the best allocation of costs. For instance, when Vanguard prepares its own universal service and telecommunications relay service filings, using the Commission's methodologies, only about 15 percent of Vanguard's revenues fall into the interstate category.

Although interstate costs generally are recovered through the Commission's access regime, it does not matter whether a cost is characterized as a local cost or an access cost, so long as all costs are recovered. Under today's regime, all local exchange carriers recover all of their costs through revenues through interstate access, intrastate access, intrastate toll, and local service, based entirely on the current jurisdictional allocation.

In other words, if the interstate charges continue to recover costs at the current level, there is no hardship on the states. Today, all the jurisdictionally intrastate calls are recovered through existing intrastate charges, and rates generally are reasonable. In fact, rates often are lower in rural areas than in urban areas.

In practice, any increase in the interstate portion of universal service funding caused by shifting costs out of the intrastate jurisdiction and into the interstate jurisdiction would be a new subsidy, in addition to those that already exist. In this case, more densely populated areas would provide additional subsidy funds through less densely populated areas.

The real problem faced by the states is the same problem that the Commission has had to confront in its own universal service proceedings. The states have to eliminate implicit subsidies and replace them with explicit subsidies.

Vanguard believes that it is best for the Commission and the states to do what the statute requires: make subsidies explicit, make them available to incumbents and competitors alike, and that the Commission should not try to readjust a jurisdictional balance that has worked well for so many years.

Thank you.

MR. KENNARD: Thank you very much. I am going to do a little switch-up on my colleagues here, and go in reverse order this time, starting with Commissioner Tristani. I am sorry to surprise you like this, but you are always prepared.

MS. TRISTANI: Mr. Chairman. I would like to ask all of the panelists if you could comment on an issue -- I think you were all here before, I hope you were. But do you read the Act - and I know some of you may not think this is relevant, but it's very relevant to me.

Do you read the Act to say that universal support, I mean universal service is a federal responsibility, or a state responsibility? And I guess, primarily, whose responsibility is that? Mr. Tauke?

MR. TAUKE: I think that the Act is very clear that it is a federal and state responsibility. Section 254(b)(5) says there should be specific predictable and sufficient federal and state mechanisms to preserve and advance universal service, federal and state.

If you look throughout section 254, there are references to federal and state.

In section 214(e), there is an -- well, 254 references section 214(e), and 214(e) gives the states the job of determining who qualifies as an eligible telecommunications for a service area, telecommunications provider for a service area. And it has the states' designating service areas.

So it occurs to me that throughout the Act it is very clear that there is a partnership between federal and state.

As we look at the Act, it is fairly clear to us that the states that have very serious high-cost problems need help from a federal fund. And so, and it seems to us logical to assume that above a certain benchmark, if a state has average costs above a certain benchmark, that they should be able to get all of that money out of a federal fund.

On the other hand, within the state, below that benchmark, the state has to figure out how to distribute funds, how to ensure that there is a fair and equitable distribution of costs across the state, and if necessary set up additional funds in order to lower that cost if they choose to do so.

MS. TRISTANI: Ms. Mandeville.

MS. MANDEVILLE: I think that the federal jurisdiction has the primary responsibility to implement universal service. The Act did not say that --

MS. TRISTANI: -- this entire equation. As you have been putting together your benchmarks, I think you have recognized that states may have some restructuring to do on their own, and set your benchmarks to look at that. I think that's within your jurisdiction to do.

And then states, probably because of competition, are going to have to take that and perhaps restructure rates below or above and beyond that, perhaps using the universal service fund on their own.

But I think that, if you will, push comes to shove, it is a federal responsibility to make sure that the mandates of the Act are carried out.

MR. LUBIN: Here is the dilemma that I see. If I read 254, it's clear that they are talking about a federal fund that needs to be explicit. They are talking about a state fund that needs to be explicit.

If I listen to what Tom Tauke referred to, he talked about looking at creating the fund using an average cost. And I'm not going to debate whether that's good or bad. But he looked at it with regard to an average cost.

When I think I heard Jim say, when he talked about his plan, he talked about, well, let's figure out based on -- he didn't use these words, but I presume deaveraged cost, based on either serving wire center or whatever he's looking at.

And so, from my point of view, there's a huge spectrum in terms of how you conduct the studies, at what level of disaggregation you conduct the studies. From my bottom-line point, clearly I believe the law is talking about a federal and state fund. But I will also tell you, today I see, across the country, roughly 25 states have just one rate for an unbundled loop. No geographic deaveraging. Maybe there's four states that have some geographic deaveraging of up to four unbundled loops.

Well, my point to you is, you know, if we don't see significant geographic deaveraging of the unbundled loop where the big cost driver is associated with rural America, then why are we talking about creating a fund using significant geographic deaveraging?

If you look at the Hatfield tool, or the HAI tool, or the BCPM tool, you see serving wire center disaggregation, maybe 10,000 serving wire centers. I don't know what the number is. If you look at census block group, there's a multiple of 10,000.

I just see that personally as insanity when I look at only one unbundled loop rate in 25 states. And so the point of does the law create pressure overnight associated with universal service for rural America, given the prices of unbundled network elements, I say absolutely not. And that's why I say, when you start looking at a different geographic area, you know, to Tom's credit, I mean, he said let's look at the average per state. My view is, you know what? I would delay the whole proxy thing because we don't have local competition.

But if you are forced to address that issue, and you looked at a forward-looking economic costing methodology for the average for a state, consistent with those 25 states that have only one unbundled loop, you are basically going to find that there is no need for an explicit subsidy. Because there is sufficient revenues to cover the cost.

MS. TRISTANI: Mr. Smiley.

MR. SMILEY: I think the Act is very clear. I think the Act is clear that the federal fund should be augmented by a state fund. And in practicality, that's how the states in which I'm familiar are allowing this to play out. They are all watching you. They are all waiting to see what you all do, the ones that I am familiar with, in terms of a national fund. And they will work on the individual state funds to supplement that.

You know, when the Act said that implicit subsidies must be made explicit, certain areas, certain states are going to have affordability problems. And I think the states know and recognize that. It is due, as Mr. Hagen said, to a very small number of low-cost customers. And what we are going to be faced with ultimately is today's interstate rate structure loads the subsidy on long-distance axis and others, we know we are going to have to deal with those issues.

And what we think with this plan that we proposed today, removing the top end of the subsidy or removing the top end of the high-cost customers, allows the states to adequately deal with what's left.

MR. GRIFFIN: I agree that the section 254 gives a very, very clear answer I think to this question. It gives the FCC and the state independent authority to preserve universal service. And I think it also suggests that the