FEDERAL COMMUNICATIONS COMMISSION

In Re:

En Banc in Connection with
Report to Congress on
Universal Service

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En Banc in Connection with
Report to Congress on
Universal Service

Friday,
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Room 856
Federal Communications
Commission
1919 M Street, Northwest
Washington, D.C.

The above-entitled matter came on for hearing, pursuant to notice, at 9:06 a.m.

APPEARANCES:

On Behalf of the Commission:

WILLIAM E. KENNARD, Chairman
MICHAEL K. POWELL
SUSAN NESS
HAROLD FURCHTGOTT-ROTH
GLORIA TRISTANI
RICHARD METZGER

State Panelists:

BRUCE HAGEN
North Dakota Public Service Commission

MARLENE JOHNSON
District of Columbia Public Service Commission

THOMAS WELCH
Maine Public Utilities Commission

CHRIS MCLEAN
Rural Utility Service
Department of Agriculture

Industry Panelists:

THOMAS J. TAUKE
Senior Vice President, Government Relations
Bell Atlantic

JOAN MANDEVILLE
Assistant Manager
Blackfoot Telephone Cooperative

JOEL LUBIN
Regulatory Vice President, Law and Public Policy
AT&T

JIM SMILEY
Vice President, Minnesota
US West

HAYNES GRIFFIN
Chairman, Co-CEO
Vanguard Cellular Systems, Inc.

P R O C E E D I N G S

MR. KENNARD: Good morning, everyone, and welcome. I am pleased that we are holding this En Banc hearing today, as we prepare our report to Congress on universal service and other issues.

As you know, the 1996 Telecommunications Act gave us many important missions here at the FCC, but two which I think are central and very important are to promote competition and to preserve an advanced universal service.

Now, sometimes people tell us that there are tensions between these two goals, and there are. I, for one, believe that promoting and advancing universal service and facilitating competition need not be fundamentally incompatible. But it's going to take a lot of hard work to make sure that our universal service system for the country remains relevant and compatible as we move to a more competitive marketplace environment. It's going to take a lot of hard work by a lot of stakeholders in this important debate.

In the four months that I've been Chairman, I've spent a lot of time studying and talking to people about universal service. We at the Commission -- myself and all of my colleagues here have reached out to the states, to learn more about this issue. We have reached out to industry groups, as well. All of us are totally committed to resolving the universal service issues that confront us as quickly as we can.

I have outlined recently eight principles for reforming universal service for the new information age. I'm very interested in hearing responses to those principles and hearing alternatives and new suggestions, as well.

Ultimately, this problem that we face in reforming universal service requires that all of us work together. There are tensions here; we have got to acknowledge that. There are tensions between the Federal Government and the states, tensions between the rural and urban states, tensions between various sectors of the industry.

The only way we get this problem solved is to do what we're doing here today, which is to get the issues out on the table, communicate with one another, and try to come up with a resolution that works as best as we can for all.

So I'm very pleased that you are all here today. We're going to have first a panel of distinguished state commissioners, and also Chris McLean from the Rural Utility Service. Rather than introduce you all now, I'd appreciate it if you would introduce yourselves before you give your presentations. I will ask you to talk for about three to five minutes. We have our able timekeeper here, Rivera Marshall, who will be keeping time.

Before you begin, though, Richard Metzger, Chief of our Common Carrier Bureau, will be giving us an overview. And before we do that, I will ask my colleagues if they have any introductory remarks. Commissioner Ness.

MS. NESS: Thank you, Mr. Chairman. I, too, want to welcome everyone who has agreed to participate in this discussion today.

As the one person here at the bench who actually participated in our prior decisions quite extensively, both as a member throughout the period of time on the Joint Board, as well as a voting commissioner, I'm quite familiar with what we did. I'm quite familiar with the agony that we went through, both at the Joint Board level, as well as at the Commission level, to come up with a very tentative conclusion as to how this could be handled under the circumstances. That is, 75/25 decision, specifically.

Personally, I've never believed that high-cost support should be based on existing jurisdictional divides. I have always believed, and have said so publicly throughout the decision-making process, that we are one nation. And that we all benefit tremendously from having every single person in this country have access to telephone service. And I do believe that Congress meant to preserve and expand that commitment, as a nation, to universal service.

But we worked, we labored very hard in the Joint Board to come up with a solution. We had a very limited period of time in which to do it, and we made enormous progress as a Joint Board. I was very proud to serve on that Joint Board. The work was difficult, but everyone worked very well together.

Some of the state members of the Joint Board also agreed that the funding for universal service should look toward both inter- and intra-state revenues. Some disagreed. At the end of the day, it was clear that this was an issue on which states were divided, and any attempt to establish a comprehensive regime would be subject to the same kind of litigation that we saw emerging at that time on the interconnection order. And certainly the Eighth Circuit decision ultimately gave us hesitation as we went through the process of determining what to do with universal service.

Thus, what we did was essentially, in my view, put in a place holder; to say if we can't come up with a better solution, this is the solution that we think is consistent with the Act, and does not impose enormous burdens on the state because we have left in place many of the implicit subsidies, largely intrastate subsidies. That has to be dealt with. And if there is additional support that's needed for individual states, let's figure out a mechanism for addressing that. But in the meantime, we came up with a solution that we thought was consistent with the Act, and urged the states to work with us in perhaps coming up with a better solution.

And indeed, NARUC, particularly members of the Communications Committee of NARUC, were very brave in undertaking to try to see if there could be a different solution. In that respect, I want to commend Bob Brough. I want to commend Tom Welsh and Dave Baker, Tom from Maine, Dave Baker from Georgia, joined by Russ Frisbee from the great state of Maryland, and Tom Delaney from New York, in trying to craft a solution bringing it to the Communications Committee, repeatedly reporting on progress, encouraging others to participate in that process.

I am hopeful -- I know we will be hearing a little bit about that ad hoc solution. I am hopeful that that process and other ideas that have been floating around at

NARUC from TIAP and others will help us to finalize that.

But I wanted to give in this opening statement a little bit of background as to why we issued the orders that we did; what our thinking was at the time, and where we are today.

Thank you, Mr. Chairman.

MR. KENNARD: Thank you, Commissioner. Commissioner Furchtgott-Roth.

MR. FURCHTGOTT-ROTH: Thank you, Mr. Chairman. And I would like to echo your fine opening statement, and that of Commissioner Ness. I look forward to both of your continuing leadership on these issues, Mr. Chairman, in your capacity as Chairman, and Commissioner Ness in your capacity as Chair of the Joint Board on Universal Service. And I look forward to working with all of my colleagues on these very difficult issues. And I look forward to this hearing.

Thank you.

MR. KENNARD: Commissioner Powell.

MR. POWELL: I have no opening statement, Mr. Chairman.

MR. KENNARD: Commissioner Tristani.

MS. TRISTANI: Mr. Chairman, I, too, want to welcome all the participants here today. And I can't help but say a few words.

As many of you know, I'm from New Mexico. I'm a former State Commissioner. In coming from New Mexico, I can't help but state that I think it is critical that this Commission ensure that universal service continues to work for all Americans.

It's because of universal service that most Americans have telephone service, affordable telephone service, whether they live in Washington, D.C., New York, or in places in New Mexico, Montana, North Dakota, all those very remote areas.

We are the envy of the world -- our technology, our infrastructure, the way we have Americans connected. I would hate to see that Americans start to get disconnected because we don't get this right.

I know that the Commission is doing everything it can, and before I joined it was doing everything it could to ensure that. But it is critical. It's, in my view, the most important thing this Commission is doing. And with that, I'd like to welcome you again, and look forward to hearing what you have to say.

MR. KENNARD: Thank you, Commissioner. We will start now with Richard Metzger, Chief of the Common Carrier

Bureau. Richard will give a brief overview.

MR. METZGER: Thank you, and good morning, Mr. Chairman and Commissioners.

Among the issues the Commission is to address in its report to Congress next month is the percentage of universal service support provided by federal mechanisms, and the revenue base from which that support is derived.

Before you hear from the two panels of experts that have graciously agreed to appear here this morning to discuss these issues, we thought it might be useful to set the stage for that discussion by providing a brief summary of the background of these issues.

As you know, Section 254 of the Act directed the Commission to reform the existing system of universal service support for high-cost areas, to make that support compatible with the emergence of competitive local telecommunications markets.

Pursuant to that directive, the Commission, in an order issued last May, acted on the Universal Service Joint Board's recommendations for implementing federal universal service support for rural, insular, and high-cost areas.

Consistent with those recommendations, the Commission concluded that federal support should be based on the forward-looking economic cost of the network facilities and functions used to provide the telecommunications services eligible for support.

The Commission further held that the amount of that federal assistance should provide support for a portion of the difference between the forward-looking economic cost of the supported service, and a revenue benchmark. The revenue benchmark is intended to take account of revenues that an eligible local exchange carrier receives from providing the supported service, including revenues from vertical services, local service, and interstate and intrastate access services.

The Commission also concluded that the federal universal service mechanism for rural, insular, and high-cost areas should support 25 percent of the difference between the forward-looking economic cost of providing the supported service and the revenue benchmark.

The Commission reasoned that assignment of this share of support to the federal mechanism approximated the cost of providing the supported network facilities that historically had been recovered by local telephone companies from their charges for interstate services. Since 1984 those costs have been recovered through the FCC system of interstate access charges.

The Commission's decision essentially requires federal universal service support that is currently recovered from long-distance companies through access charges, to be removed from those charges and recovered from all interstate telecommunications carriers through their charges for interstate services. Thus, the order largely preserved the existing division of responsibility between the FCC and the states for providing support for rural, insular, and high-cost areas.

In addition, consistent with the movement from a system of implicit to a system of explicit universal service, the Commission's order directs those companies to reduce their access charges, interstate access charges, by the amounts received from the new federal support mechanism.

The Commission expressly recognized in its order that it was not attempting to identify existing state-determined intrastate implicit universal service support mechanisms. Nor was it attempting to convert such implicit intrastate mechanisms into explicit federal universal service support.

Rather, consistent with the provisions of the Communications Act, states are, in the first instance, to be responsible for identifying implicit intrastate universal service support. As states undertook this process, however, the Commission stated that it was open to assessing whether additional federal universal service support was necessary to ensure that quality services remain available at just, reasonable, and affordable rates.

And that, in brief, at least, is the background for the two panels that you will hear over the next couple of hours. So without further delay, I would invite the first set of panelists to begin their presentations.

Thank you.

MR. KENNARD: Thank you, Richard. Commissioner Hagen, I was reading your bio, that you were serving your 37th year on the North Dakota Public Service Commission. That is quite a distinguished record of service, and we are delighted that you are here today.

MR. HAGEN: Thank you very much. It's a pleasure to be here.

Good morning. My name is Bruce Hagen. I am North Dakota Public Service Commissioner. I am here today to represent my Commission and the interest of high-cost areas such as North Dakota. And I want to thank the FCC for inviting me to be a part of this very important panel discussion today.

The FCC's proposal requires a 75/25 split of funding between the state and federal jurisdictions. The 75/25 split will threaten the affordability in some states, including North Dakota.

The cost of universal service on our customers is driven by the number of high-cost customers, the range of cost, and the number of low-cost customers over which to spread the burden.

North Dakota is an example of the worst-case scenario. It has a large number of high-cost customers, a small number of low-cost customers, and a wide range of costs.

The monthly loop cost, as estimated by the half-yield 5.0 model, using the North Dakota staff-recommended inputs for our most thinly populated census block in the northwest corner of our state, is $932 per month, per line per month, or over $11,000 per line per year. And that's, it's 50 percent higher using the benchmark cost proxy model.

What does the current proposed separated fund mean to North Dakota? North Dakota's population density is 3.42 households per square mile. The national population density is 29.31 households per square mile. A 13.7 billion national fund would require an eight percent national surcharge. A 13.7 billion separated fund would require a 42 percent intrastate surcharge on North Dakota rate-payers for 75 percent -- and that is the worst-case scenario -- of the cost, and a five percent interstate surcharge of 25 percent of the cost.

The attached graph shows more explicitly the huge burden our residents would have to assume to support a 13.7 billion national fund, at the proposed 75/25 split.

Our telephone companies are concerned about the burden our residents will have to carry. US West is concerned because its customers are uniquely impacted.

US West serves a unique territory in all 14 of its states. It serves the largest geographical area of any RBOC. It's one of the smallest RBOCs in terms of access lines. It has the fewest urban lines and the most rural lines. It owns and operates more rural switches than any RBOC. It has switches that serve fewer access lines than any other RBOC. It has a greater percentage of its customers extreme distances from its central offices than any other, than any RBOC. It has a greater percentage of its customers in ultra-low-density areas than any other

RBOC.

Our rural companies are concerned because the potential 42 percent surcharge will make telephone service for many of its customers unaffordable. Our citizens are concerned because of the heavy load they are being asked to carry.

The problem foreseen by our State Legislative Panel, and I sit on that -- it's called the Regulatory Reform Review Commission -- and by the North Dakota Public Service Commission is that in a geographically rural state like North Dakota, city-dwellers are really going to get socked. We believe there should be just one high-cost funding mechanism, the national one, even at a slightly higher cost to people in places like New York and Los Angeles.

In a letter to the FCC, Dr. Florine R. Ritano, past Director of the Colorado Rural Development Council stated, and I quote, "The FCC's 75/25 split for funding the universal service fund is a patently inequitable funding scheme that benefits the densely populated coastal states, while placing an inordinate burden on the sparsely populated frontier states of the West."

The North Dakota PFC agrees. The following table compares -- and that's on page six -- compares the burden on low-cost customers in North Dakota, Washington, D.C., and New Jersey. Low-cost lines in D.C. have no high-cost lines to support. A high-cost line in New Jersey has 6.52 low-cost lines to support them. A high-cost line in North Dakota has 1.14 low-cost lines to support them.

North Dakota, with a base of 428,000 lines, has 48,060 of those lines in very high-cost areas. In contrast, New Jersey, with a line base of 5,927,000 lines, only has 1150 of those lines in very high-cost areas, 47,000 less lines than North Dakota.

Because North Dakota high-cost customers are very high cost, the burden on the North Dakota low-cost customer is even greater.

Finally, requiring high-cost, low-density states like North Dakota to cover 75 percent of the universal service support will not ensure the federal mandate for affordability of rates. Nor will it ensure the federal mandate for comparability of rates between urban and rural areas, or between urban areas in low-cost states and urban areas in high-cost states.

Because the nation as a whole benefits when everyone can afford telephone service, everyone should share in the responsibility of ensuring that affordability. A viable national telecommunications network is in everybody's best interest, and therefore should be maintained only with a fully-funded national high-cost fund.

And I thank you very much for the opportunity to appear.

MR. KENNARD: Thank you, Commissioner. Commissioner -- Chairperson Johnson, I wanted to thank you in particular for appearing today on very, very short notice. There are advantages to having our neighbors in D.C. who can get here quickly. And I really appreciate that you were able to fit us into your busy schedule.

MS. JOHNSON: Thank you very much, Mr. Chairman. Because of the short notice, I don't have any prepared remarks this morning. But I am very happy to be here to take perhaps not quite an opposite view, but to allow the Commission to hear from a state, for the purposes of the Telecommunications Act, that is a totally urban state.

We are a low-cost state. Per capita, the citizens of the District of Columbia contribute more to the federal universal service fund than any other state in the nation. And we believe and agree with all of our other sister states that telecommunications service, basic service is important for all Americans. We are happy to contribute to that.

What gives us quite a bit of pause in the District of Columbia is the fact that the dollars that come out of our state go to support -- I don't know how to characterize them, but some citizens in rural states who choose to live in rural states, who are not or would not otherwise be eligible for universal service support.

I will pick, at the risk of being criticized later, Aspen, Colorado, where you have a number of high-income citizens who live in a rural area. And under the plan, their telephone service would be subsidized through the federal universal service support system. In the District of Columbia, we believe that that's patently unfair.

Our city is one of the very rich and the very poor, as you all know. We have the highest TRS costs of any state in the nation. Because of Galludette University, the federal universal support fund does not recognize that our citizens subsidize that TRS service. So our interests are a little bit different than the other states.

Not contrary to them.

But I would ask, as the FCC goes forward and considers universal service support and how you are asking states to contribute, to try to take into account at the fullest extent possible the varying degrees of differences among the states. We are not asking for special treatment in the District of Columbia. But as Bruce said, we are a low-cost state. We are urban. We are lucky to be urban, I guess. We don't have any farms or mountains or pastures. But in essence, the way the universal service support fund is structured now, our citizens are being penalized.

We would like to see the FCC come up with a universal service support system and funding mechanism that allows our citizens to contribute fairly. We think we are contributing to a disproportionate amount to this fund, based on the distinct characteristics of the state in which we live.

Thank you.

MR. KENNARD: Thank you very much. Chairman Welch.

MR. WELCH: Chairman Kennard, members of the Commission, good morning.

As Chairman Kennard has stated, there is no fundamental inconsistency between the Act's dual objectives of preserving and enhancing universal service, and of creating effective competition in all telecommunications markets.

Competition will ensure this country remains at the forefront of innovation and capital formation. Universal service will ensure that the benefits of competition are realized by all our citizens.

For universal service to be achieved in fully-competitive markets, however, the current framework for assisting high-cost areas of the country is inadequate and should be replaced.

Moreover, I believe the proposal contained in the Commission's May 8, 1997 order, sometimes referred to as the 75/25 approach, fails to address the fact that without sufficient direct support for basic rates, the rates for customers in some areas will be neither affordable nor reasonably comparable to the rates available in urban areas.

Let me describe both the nature of the problem and the outlines of a possible solution.

As Commissioner Hagen has just graphically described, there are many states where the number of customers served in high-cost areas is so large relative to the number of customers served in low-cost areas, that if left entirely to its own resources, a state would have to impose enormous surcharges on its low-cost customers to bring its high-cost customers within hailing distance of either comparability or affordability.

A comparison of two states -- California and Vermont -- illustrates the problem. In both states, the cost per line measured on a forward-looking basis is roughly the same for each density zone.

For example, where the density is from five to 100 customers per square mile, the costs in both states are a bit over $40 per line. Where the density is over 10,000 customers per square mile, costs for both states are around $10.

But there is no similarity between California and Vermont when you measure the proportion of lines in each density category. In California, fewer than five percent of the lines are in the five-to-100-density zone. In Vermont, about 30 percent are in such sparsely populated areas.

On the other hand, in California more than 30 percent of customers live in areas where there are more than 10,000 lines per square mile. Vermont has only about five percent of its customers in such typically low-cost areas.

Unlike California, Vermont simply does not have enough low-cost lines to offset the higher-cost lines, and reach a balance that is consistent with the Act.

The existing system for distributing support to high-cost areas cannot reasonably coexist with a competitive market. Because, among other things, the amount of support available to an entrant or to an incumbent would depend upon the characteristics of the incumbent -- for example, whether it serves more or fewer than 200,000 lines.

In the old days of implicit subsidies, it may have been expedient to differentiate among carriers based upon their size. Where subsidies must be explicit and portable, such distinctions are untenable.

The 75/25 approach likewise falls short. First, by directing support to reducing interstate access rates, the proposal fails to provide any federal support at all for local rates for customers living in high-cost areas. That obligation would fall entirely to the states.

Second, because this approach would fund only 25 percent of the need, states with a disproportionate number of customers who live in high-cost areas will simply be unable to meet their burden without vastly distorting the rates that must be charged to customers in their relatively few low-cost areas.

There is, however, another way. Chairman Kennard has articulated the purpose of a federal high-cost fund as a safety net. I suggest that net should come into play where states cannot, by virtue of their geographic characteristics and the distribution of their populations, generate for themselves enough support to ensure that all their citizens enjoy basic telecommunications services at rates that satisfy the Act's standards for affordability and comparability.

Put another way, the amount of federal support available to any state would be limited to the amount needed by that state that exceeds the amount that the state can raise from within its own borders by balancing its own low- and high-cost areas. The amount of federal support would thus assume that each state has taken care of its own. This approach expressly recognizes that the universal service obligation of the Act is appropriately shared by the state commissions and the FCC.

The proposal accompanying these remarks, which is a slightly revised version of an ex parte submission filed on February 10 by the Commissions of Maine, New -- of Vermont and New York, outlines an approach that may serve as a useful model for reform of the high-cost fund.

The proposal grew from efforts by state commissioners representing a broad range of interests to see if we could find common ground. We recognize that any sound approach should be consistent with the needs of competition, should provide sufficient support to satisfy their comparable rates standard of the Act, and would necessarily involve significant compromise by all.

While we continue to work to refine the proposal, I believe it represents a fair and balanced model that could serve effectively as we move into the uncharted waters of local competition.

We do not have time this morning for a full recitation of the proposal. In broad outline, federal support would be given only where a state's average costs, measured by the lesser of imbedded or forward-looking costs, exceeded the national average.

The proposal also includes provisions to ensure that carriers and their customers who receive support under the existing system are not placed at a disadvantage. We estimate the proposal will result in only a modest increase in the overall level of high-cost funding, and thus, in our view, would keep the fund at a level that does not impede the growth of competition.

The states, including Maine and its rural counterparts, are committed to opening our markets and bringing the benefits of competition promised by the Act to our citizens. We are just as committed to finding a way to be sure that the telecommunications needs of our citizens who live in the areas that are costly to serve are met at affordable rates that are comparable to the rates available to their more concentrated brethren.

I encourage you to consider the approach I have outlined today. Thank you for the opportunity to be here this morning.

MR. KENNARD: Thank you very much. Mr. McLean.

MR. MCLEAN: Thank you, Chairman and members of the Commission. It's an honor and pleasure to be here today.

Universal service embraces the very essence of America -- one nation, indivisible. No principle is more fundamental to telecommunications policy. The Communications Act of 1934 has as its purpose to make available to all people of the United States a rapid, efficient, nationwide, and worldwide communications service, with adequate facilities and at reasonable charges.

Sixty years later, the Congress and the President sought to secure the promise of the 1934 Act by making universal service the central focus of the

Telecommunications Act of 1996.

In evaluating the 75/25 percent proposal, it should be applied to those principles of universal service contained in the Act. The Rural Utility Service believes that the 25 percent limitation on federal support conflicts with the Act's universal service principles.

Will it provide just, reasonable, and affordable rates? Leaving individual states responsible for 75 percent of universal service costs will have a profound and dramatic effect on rates. Participants in this proceeding have reported that rates will need to increase in 39 states to maintain current levels of service.

In South Dakota rates would increase 50 percent. In Wyoming recovery would need to increase by $51.75 per customer.

Does the proposal provide for comparable rates and services? Given the great disparities between each state's ability to absorb 75-percent responsibility for universal service, rates in rural areas will certainly increase, and quality of service will certainly decrease. States with the greatest universal service burden are states with the highest costs, largest geography, and smallest populations.

In urban areas and profit centers, competition will drive down rates. The result will be vast differences between rural and urban rates.

Infrastructure is simply more expensive in 80 percent of America that is rural. The Rural Utility Service works closely with over 900 small, rural telephone companies and cooperatives to provide reliable, quality, and affordable telecommunications services.

On average, plant costs for those service providers are three times the costs of their urban counterparts.

Does the proposal provide for an evolving level of service? The Act defines universal service as an evolving level of telecommunications services established by the Commission, and once established, supported by federal universal service support mechanisms.

Under the current universal service formula, rural states with the greatest need will be unable to provide sufficient support for existing levels of service, let alone provide for new, evolving levels of service.

Is the plan equitable and non-discriminatory? The 25/75 plan is not equitable, because it places the highest burden on consumers in the most rural states. It is discriminatory because it does not require all telecommunications carriers to contribute and to support universal service as required by the Act.

Is the plan specific, predictable, and sufficient? The May 8 order does provide for a specific and predictable level of support, but one which is not sufficient to support the federal definition of core services at just, reasonable, and affordable rates.

There are a host of current federal mechanisms of universal service support, including DEM weighting, the averaging of access costs, current universal service fund support, and long-term support. The 25-percent limitation on future federal universal service support will not equal even the current levels of federal support.

Measured against the act's universal service principles, the 25-percent plan does not appear to comply with the Act.

The uncertain environment related to the future availability of federal support is having an adverse effect on infrastructure investment in rural areas. Our US borrowers are reporting a reluctance to invest in new plant and equipment, due in part to the uncertain universal service environment.

It is important that the Commission develop an open and clear transition plan that sets forth markers for meeting the goals of the Act -- an open competitive market, an adequate, sufficient universal service support -- while mitigating unnecessary rate impacts on individual consumers. The federal commitment to universal service predates the creation of this Commission. The Telecommunications Act of 1996 changed a great many things, but did not, but it did not change that fundamental federal commitment.

The Rural Utility Service has been pleased to comment on this and other proceedings. We stand ready to assist the Commission in assuring that the promises of the Communications Act of 1934, the Rural Electrification Act of 1936, our authorizing statute, and the Telecommunications Act of 1996 are kept to all Americans of this one nation.

MR. KENNARD: Thank you very much. Questions for our distinguished panelists? Commissioner Ness?

MS. NESS: Thank you, Mr. Chairman. Commissioner Hagen, on average, what do residents of North Dakota pay for local service?

MR. HAGEN: In the cities like Bismarck, about 12 and a half. In rural, it can average -- we have one, practically nothing, down around six dollars I think it is in Minot, up to about $25, $26, Consolidated Telephone

Company, in rural. They serve around Dickinson and the western part of the state.

MS. NESS: Chairwoman Johnson, can you tell me, please, on average, what your residents of the District of Columbia pay for local service?

MS. JOHNSON: On average, the monthly rate is about $13. We have quite a few subsidies for citizens of the District of Columbia. We have rates as low as one dollar for senior citizens that meet certain income guidelines. We also have a basic message rate plan for many of our citizens at three dollars per month, again subsidized for the low-income citizens in the District of Columbia.

MS. NESS: Commissioner Welch?

MR. WELCH: The basic rates currently hover around $12 or $13, although we have before us a proposal right now that would reduce our very high access charges and raise basic rates by about another $3.50. So they may go up to about $15 or $16.

MS. NESS: I ask that because, implicit in everything that has been said has been the cost to the consumer. And I am very concerned about the cost to the consumer, so that all of our citizens can afford telephone service. But the rates vary from state to state, from city to town, whatever it might be.

Is there a way of -- do you look at that issue in your ad hoc proposal? I raise that because the Commission had a benchmark which was based on the revenues per line. Yours is based on the cost to the carrier per line. Can you comment a little bit on the pros and cons of those two approaches? And what that means, as far as what the individual consumer pays for service?

MR. WELCH: Yes, I would be pleased to. One of the reasons the ad hoc proposal selected a cost basis rather than a revenue basis is that revenue comparisons tend to be very difficult. And the example I gave for Maine's rates is probably indicative.

If you just looked at Maine's basic monthly charge, it would appear to be lower than, say, the charge in D.C. If you combine it with Maine's toll rates, which average about 50 cents a minute at times, it's not clear that that comparison is apt. And in fact, there is a lot of rebalancing going on around the country that makes any snapshot picture just looking at a particular rate difficult to achieve.

So we addressed it by, in a sense, assuming that a state would do what it needed to do in the rebalancing area.

And in terms of balancing its own internal subsidies. So that if you match the cost components of the USF, you would ultimately enable a state to reach parity to the extent that particular state believed it was essential, through the kind of USF funding we are describing.

MS. NESS: Okay. Does anyone else want to comment on that issue, of what a consumer pays versus what the cost of the line might be? Any other comments? Chris?

MR. MCLEAN: I would think it's important to realize that a six-dollar line in a place perhaps like North Dakota or another rural area is only able to have a calling scope that could reach a few hundred people. So that it's not a fair comparison to look at the cost to the District of Columbia, where you could reach perhaps several million people for a local rate.

MS. NESS: Okay. In your ad hoc proposal, Commissioner Welch, you talk about holding harmless, I believe on a company-by-company basis. So that a company that is getting a significant amount of support presently would continue to receive exactly that amount, if not more. Is that correct?

MR. WELCH: That is correct.

MS. NESS: What incentives would be built into your proposal to encourage cost savings? We are in a declining-cost industry. And if we are just holding harmless, what would be the incentive for a company to try to reduce its costs?

MR. WELCH: I think you would be left with, although I don't want to understate the importance of this, the traditional role of the State Commissions to ensure that rates are provided at efficient, at efficient costs. And we would expect that, as competition began to drive costs down, that the benchmarks against which the performance of any particular company would be measured, even the smaller companies, would tend to drive, to force that company to meet standards of greater efficiency. Regardless of the level of federal support it was given.

MS. NESS: In talking about the need to make sure that all citizens have affordable telephone service, Commissioner Hagen and Chris McLean, you talk about it having to be a federal subsidy. The federal subsidy so far has been referred to -- and I believe, Commissioner Welch, your proposal also refers to it -- as being from interstate carriers. The Act provides that it has to be interstate carriers.

The question is, should it be pulled from or based upon revenues that are interstate revenues or intrastate revenues as well? Would the three of you comment on the issue as to whether or not we ought to be pulling from both inter- and intrastate revenues of interstate carriers? Or should the burden be solely on the interstate portion to fund what is essentially an intrastate service?

Commissioner Hagen.

MR. HAGEN: I suppose you would probably naturally like to have just an interstate fund. But you have to be fair, and we know that. And in spite of what I testified, and that is our position, I happen to like Tom Welch's study very much; I think there is a lot in there.

I think you really have to look at probably interstate and intrastate. But work out something that is fair.

The FCC has got a very tough job. And I think I speak for all Commissioners in all 50 states. We know it. We know you are working hard at it. And the fact that you are listening to us is tremendous. And we have great faith that when you put all of the A through Z things together, we are going to be coming out all right.

And I would say even further than that, even if it doesn't work 100 percent of what we all may want and like, you can correct it down the road.

MS. NESS: Commissioner Welch.

MR. WELCH: I certainly agree that a case can be made that any funding should be drawn from as broad a source as you can find.

I think that the ad hoc proposal addresses the question of funding with a horizontal cut, in that the states, to the extent they would need to provide the balance within themselves, would be drawing from their own resources to get up to this nationally average level. And only after the states had reached that level would any federal support kick in.

So under the proposal, we consider it appropriate for that to be the portion that would come from interstate revenues. Because the plan sort of assumes that you have picked up whatever you need to to get up to the national average from intrastate revenues.

So I think it would be appropriate to have this, this safety net federal fund drawn from interstate revenues.

MS. NESS: Chris?

MR. MCLEAN: First, we would prefer that the term be support. We don't consider universal service to be a subsidy. And the service has observed that the Commission's approach to schools, libraries, and rural health care would comply with the principles of the Act. So that is certainly an option that I believe the Commission acknowledged that it has the power and authority and jurisdiction to take a national approach. And certainly we wouldn't have as many difficulties with issues of comparability and sufficient levels of support to assure just, reasonable, affordable rates.

MS. NESS: Commissioner Welch, your -- can you tell me how many states, both high-cost states and then low-cost states, support your ad hoc proposal?

MR. WELCH: I want to be careful in my response, because we have never polled them for whether they agree with everything in the plan.

There were 14 states who signed a recent pleading to this Commission, states both high- and low-cost, who indicated general support. There are states other than that who have also indicated varying levels of support, and there are a number who have expressed indifference. And there is a small number who have opposed it.

I think the support comes from both high- and low-cost states. And we continue to work to see if there are particular ways in which the plan can be adapted to assure that the legitimate concerns of other states are addressed.

MS. NESS: Okay. Chairman Johnson, do you feel that it is inappropriate for a low-cost state to provide any support for expenses in a high-cost state?

MS. JOHNSON: Oh, absolutely not, Commissioner Ness. We believe that the District of Columbia ought to pay into the fund. I mean, I have had a chance to look at Commissioner Welch's plan. I believe that it is probably the fairest approach to it, by asking states to take care of their own first out of intrastate revenues, and have the Federal Government subsidize or support whatever the remaining amount is.

By no means do I wish to suggest by my remarks that the District of Columbia believes that it should not contribute to the universal service fund. Our difficulty is that we are a paying state, a payor state, in all instances, under any scenario, including the one developed by Commissioner Welch. We are simply asking that, as the FCC develops its plan, you take into account the peculiarities of our state as you try to decide how much you are asking our citizens to contribute to a federal universal service fund.

MS. NESS: Without expressing any comment on the substance of your plan or an opinion on the substance of your plan, I do want to thank you so much for all of the effort that you and fellow commissioners have made toward coming up with a solution. It is an extraordinarily difficult problem, as Commissioner Hagen so eloquently stated. And it's one that, for me, I'm particularly grateful so many state commissioners have really rolled up their sleeves, have looked at it as an issue that affects the entire country, as opposed to the specific interests of their own state, and have really tried to work together to come up to a solution.

So I want to thank all of you for that effort. And that is the end of my questions, Mr. Chairman.

MR. KENNARD: Thank you, Commissioner. Commissioner Furchtgott-Roth.

MR. FURCHTGOTT-ROTH: Thank you, Mr. Chairman. And I would like to thank the staff for putting together this very fine panel and this entire hearing this morning. And I'd like to thank the panelists for their very informative views.

It's always a pleasure to hear from the states. And it's always a pleasure to see Chris McLean, who has always been a very forceful and articulate advocate for rural interests.

Commissioner Ness has done a very fine job of asking several questions that I had hoped to ask. And I just would like to follow up on a couple of these.

Chairman Johnson, I'd like to go back to the question of your views on whether a federal fund can, whether the FCC has the authority to develop a federal fund based on intrastate services. I think Commissioner Ness asked directly to the other three panelists, but I wasn't quite sure I got your answer on that.

MS. JOHNSON: I believe so, Commissioner. I think that it is -- I mean, I agree with the other panelists, that you ought to draw support from as broad a base as possible, quite frankly, which is why personally I am supportive of Commissioner Welch's plan.

I believe that support ought to come from both intrastate and interstate revenues, and measured perhaps by cost. But I believe it's unfair -- not unfair. But I believe it would be a fairer approach to draw the support from both, as opposed to just interstate revenues.

MR. FURCHTGOTT-ROTH: Commissioner Welch, would you characterize your plan as --

MR. WELCH: The way the plan is currently drawn, there would, for the safety net provision, which is really all that the federal fund would be, that would be drawn from interstate revenues.

I think it's a little unfair to characterize it as having, as being a universal service plan that only draws from interstate revenues, because the -- each state taking care of its own provision would require, I think, the states to draw considerable resources from within themselves in order to reach the level, sort of the threshold before federal support kicked in.

MR. FURCHTGOTT-ROTH: I was wondering if I could ask each of the panelists how they interpret subsection F of 254, which is the state responsibility for universal service, state authority. Particularly the last sentence. And I don't mean to get you to review in detail the statute. I'm not a lawyer, and I'm not going to pretend to be one.

But I'm particularly interested in issues regarding conflicts between state authority and federal authority to collect for universal service mechanisms, and the statutory requirement that state mechanisms not interfere with federal mechanisms.

How do you all interpret this in terms of how you all envision intrastate or your state universal service plans?

MR. WELCH: I am only a recovering lawyer, so I don't want to speak as a lawyer.

How I envision the system to work, however, I will respond to.

I think that it is, that the responsibility to ensure the universal service objectives of the Act are met is a responsibility that is shared by the FCC and the State Commissions. I think it is appropriate for the FCC to view its role as filling in the gaps, where a state cannot achieve what it needs to.

I also think it is incumbent upon the states to develop, to the extent they need one, universal service mechanisms that do make explicit whatever subsidies may exist in their rates.

So whether or not it is technically a requirement of the Act, I think it is both consistent with the overall objectives of the Act and with the objectives of the State Commissioners, as I know them, to develop plans that are consistent with both ensuring universal service and ensuring that that's done in a procompetitive and explicit way.

So I would see the role as the states developing their own universal service mechanism that would provide sufficient support, as I've indicated in the plan. And then the federal support would be sort of brought in on top of that, where needed.

I do think there is a role for this Commission, for the Federal Communications Commission, to ensure that where there are federal funds being brought into a state, that those ought to be distributed in a way that the FCC considers to be appropriate in the FCC's eyes as being procompetitive and consistent with the Act. So I think some standards and objectives are entirely appropriate.

I think states ought to have some degree of freedom to craft particular kinds of universal service support that are appropriate for their own circumstances, but within some guidelines.

MR. HAGEN: I would agree with what Commissioner Welch said. I really don't have any problem with it. I'd just add to that, our state still doesn't have a state universal service fund. But if I had to predict anything in the next North Dakota Legislature, which starts in '99, coming from the Regulatory Reform Review Commission that I sit on, that's exactly one of the bills that will come out of that Commission and go to the Legislature. And I think it will pass.

We have all of the authority right now to do this, but we do not have taxing authority. And the legislators, there are four legislators who sit on that Commission. And they know we need a state universal service fund, which will do part of what Tom was talking about. So I think that's going to happen in North Dakota.

MS. JOHNSON: Commissioner Furchtgott-Roth, in the District of Columbia we have a universal service fund and a local Act which requires us to expand that fund. It's obviously expanded out of intrastate, it's funded out of intrastate revenues.

It serves to support our low-income citizens, our senior citizens. And under a new local Act we also have to consider support to our handicapped citizens, as well.

I don't believe that, although I am a practicing lawyer -- I hesitate to say this. But I don't believe that the sentence in the Act that you have directed our attention to obviously would not provide a problem to the District of Columbia. And I have to agree with Commissioner Hagen and Commissioner Welch, that I still don't believe this would keep a state, this particular provision would keep a state from adopting a universal service support system within a state that would allow it to take care of its own. I just don't read this that way.

MR. FURCHTGOTT-ROTH: I certainly did not suggest that anyone should read it that way.

MR. MCLEAN: I would say that, first, the state mechanisms have to be consistent with the federal mechanisms. And that states are permitted to do supplemental, supplemental universal service, such as a dollar rate for senior citizens that may not be contemplated by the federal system.

I would like to quote three of the commenters in this proceeding -- Senators Dorrigan, Kerry, and Rockefeller -- who were three of the authors of this provision when it was in the Senate. And they say the Act called for a coordinated federal and state universal service system, where state support mechanisms were intended to augment federal support systems, not the other way around.

MR. FURCHTGOTT-ROTH: Thank you very much.

MR. KENNARD: Commissioner Powell?

MR. POWELL: I would like to ask an open-ended question, which I think is another side of this equation that is not really being addressed that squarely on the panel.

What do you all believe Congress's objective was by making the system explicit rather than implicit? What did it hope to achieve?

Because by varying degrees, one might say that if some of the objectives expressed here today were the most desirable ones, or were the central import, as Mr. McLean suggests, of the Act, you don't necessarily have to do that.

And so I would ask what people think Congress intended or we are trying to achieve by going from implicit to explicit. Chris, you were there. Maybe --

MR. MCLEAN: Well, I think that there is an unnecessary mysticism about the idea of explicit. The term explicit means known, revealed, understood. So just the simple act of identifying and quantifying an implicit support mechanism does convert it to an explicit support mechanism.

And the importance of that process is to be able to know whether that support is known between carriers, and that the support burdens are shared on an equitable, non-discriminatory, competitively neutral basis.

So there, the idea of explicitness doesn't mean taking charges from one place and putting it to another, or having a certain way of rates being reflected. It just means that the obligations are known; that the costs are known. And the section specifically refers between carriers.

So I think that there is a little bit too much being read into that idea. Once we know what all of the support mechanisms are, then we can evaluate whether they are fairly shared.

And in drafting the statute, Congress moved away from language that talked about the universal service support fund, and included provisions talking about universal service support mechanisms. So I think that's what you have to bear in mind when you look at the Act's direction towards explicitness.

MR. POWELL: I'll come back to that in a second.

MR. WELCH: I think the Act's requirement for explicit mechanisms is really a necessary corollary to moving to a competitive local environment.

You want carriers to compete based on their underlying economic costs. As soon as you say that, you have to find a way of extracting from the historic rate structures that have grown up the things that are unrelated to those costs, and making them portable. And I don't think you can do that unless you make them explicit.

So I see it as really central to that component. I think that if you were to ask me to speculate about the motives of Members of Congress, I would not do so, except to say this. I think there is probably also a growing trend towards making sure that people know what they are paying for. And that support mechanisms, like many other things, ought to be exposed to particular public scrutiny. So that may have been in the minds of some.

But even without that, I think that to go to competition, you have to make those explicit.

MR. HAGEN: I would agree with both Commissioner Welch and Chris McLean. I think, as I understand it, they are probably both right. And I guess I wouldn't try to guess at the motives of Congress, except only to say that maybe some of them regret making it explicit, because people tend to think, well, there's another tax on top of whatever.

I happen to think Congress, when they talk about taxes, should be up front and say this is a tax that's needed because we live in a civilized society, and that's the way it is. You've got to pay some taxes, as you have to pay these costs in the telephone arena. We've got a terrific telephone system, best in the world. It didn't just happen. It happened because a lot of people wanted it, supported it, and it costs some money.

MR. POWELL: Well, I asked that question in part to somewhat get at the answer that Commissioner Welch offered, which is the -- my firm belief that implicitity/explicitity also is embedded in that it's the command to be sensitive to economic efficiency as a necessary component of ushering in the competitive environment that I personally believe Congress was equally as committed to as the components that reflect universal service. And in there lies what I think is a tension.

And I just think we can't lose sight of that fact. Which raises questions such as, when you're balancing whether you continue to maintain, I think as Commissioner Hagen suggested, 100-percent federal fund, which means interstate, which means access charges, which have economic and competitive consequences. And we can't push aside those potential consequences without some consideration of making sure we are making judgments about what we lose in the one and the other.

I suppose that we also have to be willing to say out loud that implicit to explicit means there are going to be some revelations that are not going to be comfortable. And I don't think anybody was -- I'd be surprised to hear that anyone believed that anyone was naive about that.

It was going to reveal the situations that Chairperson Johnson has pointed out. And it seems to me, I, at least, interpret in that an obligation to take serious consideration the concerns of equity among America's states, as we try to rationalize this system. So I think it is a serious and overriding goal.

Commissioner Hagen, sort of with that as a set-up, I'm curious whether you have concerns as for the residents of your state, that if, for example, as you urged, there was 100-percent funding from federal mechanisms, what impacts those would have on your customers' long-distance rates? What impacts those things might have on bringing competition to your state? And whether you are suddenly reflecting a judgment that you don't believe that competitive forces will prove as valuable to your consumers as they might elsewhere?

Mr. McLean made a good point about comparing rates because of who you can reach. But it also highlights the importance of who your consumers may need to reach who are at long distance from you. And that's going to be impacted if the access charges reinstate.

MR. HAGEN: I think we are aware of that. And as I said, what I was talking about isn't written in stone. I like Tom Welch's. But yeah, there would be some impact on long-distance rates. That's a given, I guess.

But I guess I've got confidence in the long run that it is just going to work out.

MR. POWELL: Me, too, I hope. Mr. McLean, I don't really, I don't mean to be flip about this. But I'm curious, when you say it's not a subsidy, it's a support. What's the difference, in any meaningful way?

MR. MCLEAN: Oh, it's a huge difference. First of all, this entire Act is about universal service. Competition is a mechanism, a means of providing universal service.

When we talk about support, it's about how we share the costs of that network. We have to have one national network.

My ability here in Washington, D.C. to call a friend in Scotts Bluff, Nebraska isn't just valuable to the person in Scotts Bluff. In fact, some would argue that that may be a negative. But it is valuable to me in Washington, D.C. to be able to reach out to any place in the United States.

The value of any phone is its ability to reach any other phone. And so that's a shared cost. It's a shared responsibility. It's not a subsidy. It's not doing a favor for the people in rural America. It's that rural America is part of this one nation, and that rural America needs to be part of this network, because that enhances the value of the network.

Every additional person we put on the network enhances the value of the network, even for the easiest-to-serve customers. Competition will provide universal service at just, reasonable, and affordable rates for most consumers. But there are areas where competition just won't do the job. And that's why we need this support mechanism, and the shared cost to do that.

MR. POWELL: I suppose that's fair. But I would just say that we have an obligation to also be careful in shifting our definitions of universal service when they are convenient. That is, there are differences between what can be achieved if you mean ubiquity, and what you can mean when you say affordability. I have no doubt that competition can produce ubiquity in the value of --

MR. MCLEAN: But ubiquity and affordability are linked.

MR. POWELL: Not necessarily.

MR. MCLEAN: If rates go to --

MR. POWELL: Not when you start, not when you start with, you know, a history and a legacy of a monopolistic system.

MR. MCLEAN: If rates go to $150 in North Dakota, which they might in a world without universal service support, those citizens will give up the telephone. They will not, they will fall off the network. We will not have as ubiquitous a network as we would otherwise have.

So ubiquity and affordability are linked.

MR. POWELL: That's all I have, Mr. Chairman.

MR. KENNARD: Commissioner Tristani.

MS. TRISTANI: Mr. Chairman, I just have a couple of questions. I know that we are running a little over our time.

I'm kind of a little troubled, or maybe I'm having difficulty understanding. And Commissioner Welch, I hate to pick on you, but you were the first to answer Commissioner Furchtgott-Roth's question about section F.

And maybe I read the Act differently, and I think maybe I read it a little bit more like Mr. -- like Chris. But I thought we started with kind of the federal universal service fund. And then states, if they could, if they wished, could add onto that.

And I think it's wonderful for those states that can maybe do more than that, and perhaps be the first ones on line. A lot of states already have funds. But I know there are a lot of states that don't. And I know there are 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 funding mechanisms should be limited to their area of jurisdiction. So that the FCC should obtain funding from interstate carriers, and the states from carriers of any specific state.

But clearly, it gives the responsibility to the FCC and the states jointly to accomplish the universal service goal.

MS. TRISTANI: Thank you, Mr. Chairman.

MR. KENNARD: Mr. Powell.

MR. POWELL: As representatives of institutions that are either competing or preparing to compete, both in existing markets and new markets, I'd be interested in hearing some elaboration from the perspective of each of your companies what the ultimate impact of the outcomes of these decisions will have on your relative competitive advantages or disadvantages. Both in terms of local competition. In the case of AT&T, how it affects its ability to enter new markets. Long distance companies. Local exchange companies who, how it will affect their ability to compete in long distance.

And just as importantly, how you think it impacts your ability to innovate and compete in new and emerging markets that aren't normally the subject of the discussion in these sorts of things. Because money coming out here is not used somewhere else. And I'd be curious to hear your perspectives on all three of those markets.

Do you want to start, Mr. Lubin?

MR. LUBIN: Sure. The reason why I said what I said in terms of my opening comments is that -- I am going to back us up to the FCC's order on access reform, where it looked at the prescriptive approach, it looked at the market-based approach. And it came in, and asked a series of questions of, how can we do prescriptive, how can we do the market-based.

And I remember there were certain key paragraphs that I always looked at that says, hey, we have unbundled elements. They are deaveraged. We have forward-looking economic pricing for the setting of the unbundled network elements. And if you get that or the combination thereof, you don't pay access. And there was a wonderful paragraph that said, and by the way, you've got to make sure that these operating support systems are truly operational. And the next sentence was, and can carry significant volumes.

And when we looked at that, we obviously wanted a prescriptive approach. But we saw at least intellectually that that could work. The problem is it was an intellectual solution, which effectively has not been operationalized. And because that is not operationalized, we see access prices that are inflated. We see the fact of trying to deaverage the subsidy for universal service. They call it March Madness, in terms of trying to figure out how do I solve the universal service problem when loops are not deaveraged?

And so from my point of view, adding on top more costs to me, and then I have to pay 92 percent of the LEC assessment in terms of the access that they float to me that I then recover from my customers, our bottom line is we are going to have great difficulty.

And right now we see a size of a fund at 4.9, assuming schools and libraries go to where it may -- maybe it doesn't, but if it does. And then on top of that, we are seeing more high costs coming to us. So our bottom line is, yeah, we have a real problem in terms of trying to figure out how to come into this market.

My view is -- and I'll just take, you know, 30 more seconds -- we have a real opportunity to try to create competition. Unfortunately, you have an IXZ and a local exchange carrier both touching the same customer. Both touching the same customer. And when they are ultimately meeting the checklist, and in the intralata marketplace competing against us, if we do not have a mass offer to offer customers in a profitable way into the residential marketplace, my view is we will not be an effective party into that residential marketplace.

And so what I call March Madness is the concept of deaveraging this subsidy to either wire center or below. And again, I don't know, there are thousands and thousands of wire centers. But I'm only seeing 25 states with one unbundled loop, and maybe four or five with four deaveraged loops.

So the logic construct is just not there. I don't understand it. And my bottom line is, yeah, you have people at AT&T very, very concerned that this isn't working. The market base clearly is not working. And so we see a significant dilemma when access prices remain high. Maybe they come down somewhat because of USF reform. But from our point of view, if that isn't working, why are we fixing USF?

MR. SMILEY: Let me talk about this from US West's point of view. One of the things that will happen in the rural areas if the universal service fund is not sufficient to support the rural areas, you will see what happened when the interstate highway system went in.

You can look at population density maps. And you can plot the interstate highway systems by the color codes for where the densities are. You can actually go through a state like North Dakota or Wyoming or any of these states, and where the population centers, small as they may be, in those states are is right along the interstate highway system. There are some anomalies, but not very many.

Our concern is that whether it's us providing the service, whether it's the small telephone companies providing the service, or whether, to your point, Commissioner Powell, competition will ever exist in the rural areas, without an adequate fund you won't see the competition develop in those areas.

We will not invest. Others will not invest. And competition will not become robust. And you will see the same density maps for the information superhighway that you see for the current highway system.

And that's why federal support from all 50 states is necessary for each and every state, not have it confined to the boundaries within the state.

MR. GRIFFIN: From the perspective of the wireless industry, we have one primary goal, which is access to the subsidy so that we can go in and try to be the provider in some of these areas. And in fact, there are a number of instances where, with access to the subsidies and even without, that we're able to come in and provide, in unusual situations, the very best service.

And if the Commission can do that and can, the other goal, just to add that the wireless industry has for the Commission is the implementation of -- if we can do that, that would really put us in a position to be an effective provider of local telephone service, and go a long way towards helping to create competition with the benefit of explicit subsidies that, in fact, are portable.

MR. TAUKE: On your question about how this affects competition. If I am a local exchange company serving a community where the average cost of service is

$50, and I can get a $30 subsidy out of, some from someplace, and my competitor cannot, obviously the competitor is never going to offer service in that community.

So it's essential, if there is a support mechanism that is flowing into a company from outside, that that support mechanism be explicit. And I think Congress intended that, and made that clear in the Act.

I think it's also important to note, however, that Congress didn't say that if you are charging three dollars for voicemail today, that you have to lower that to 10 cents, and make the $2.90 part of the cost of local service.

I think Congress recognized that in a competitive market, when you price, you have the story sometimes like the razor and the razor blades. Dial tone is often like the razor, and it will become more so as we move to a competitive marketplace, where the price of dial tone will go down because that's the access that the company has to the customer. And the price of other enhanced services -- the vertical services and other things -- will be held at their current levels in order to make money off that customer.

So I think the key is not looking at each element of the price of the service that the provider offers to the customer. The key is looking at what kind of money that company or provider gets from somebody other than the customer in order to support service to that customer. And that source of funds ought to be explicit.

So I think that's how it affects competition in the local exchange market.

When we look at other markets, a company like Bell Atlantic, let's say, is going into the PCS business through Primeco. If this fund becomes so large that a company like Primeco has a substantial economic burden to support the universal service fund, without any realistic expectation of being able to collect money from the universal service fund in the foreseeable future, that's going to be a deterrent to the ability of the PCS company to survive and grow. And also, parenthetically, compete effectively with the wire line company.

So you have to make certain that we don't have a fund that becomes so heavy, if you will, or expensive that it thwarts the development of the new alternative services that are out there, and supports too greatly the existing wire-line-type technology that's already in place.

So I think that's how it would affect the competition for new services.

MS. MANDEVILLE: As I mentioned, we are headquartered in Missoula, Montana, which is, from a Montana perspective, an urban area; it has about 50,000 people. And we are looking at competitive ventures in that area.

And I think, like so many competitors out there, it is not that structure today does not create competitive opportunities, because it does. Certainly there is a decent amount of uncertainty as to the pace of change or sudden changes that may come up.

Montana is one of the states that has a single unbundled network element for loops. It is not the average. And yet, business rates are also at about two and a half or three times residential rates. That creates enough space between the unbundled network element and the business rate of US West to offer alternative services.

If suddenly the state would restructure the business rates, and not restructure the underlying network elements, it would suddenly create a problem. So many of our answers are in keys to timing. Each time carriers don't pass through carrier access charge reductions into long distance services, it creates a new competitive opportunity.

I think those are out there today. They'll get skinnier and skinnier as time goes on, and we reflect in the rate structure the actual cost of each service.

MR. POWELL: Well, just to sum up, I mean, it probably states the obvious. But what you hear in what everyone says is that, at bottom, these things are the imposition of costs. And those costs will have consequences. And we are balancing two places where those costs hit. When they hit the consumer directly. But when they also hit those who provide the services to consumers in a way that ultimately can, if not done carefully, frustrate the ability for those companies to get to a position in which they can offer those customers not only new services, but competitively-priced services.

And I suppose the other theme for me that I hear in everyone's words are that we have to be very careful that no matter what costs we pose, they don't provide competitive advantage and disadvantage to companies who historically have been separated from competing, but now are looking to each other as opportunities. Though they have historically paid in in different ways, there will need to be a greater rationalization of the way and manners they pay in order to put them on similar competitive footing.

So thank you. And I just have one very simple question, Ms. Mandeville. You talked a little bit about what you anticipated to be the impact of rates on a customer. And I assume that to not include what may even be additional costs to the consumer were the state to begin to have a state-operated universal service fund that will impose also costs on existing competitors in your community, and then find its way back on the bill, as well.

MS. MANDEVILLE: That's true, it doesn't include those costs. But I would also say that those customers, if that state restructuring is done, should be the big winners. Long distance customers in the state, if carrier access charges fall drastically, which would create a need for a universal service fund, their total bills should go down.

Business customers that today pay two and a half times the cost of residential, yes, they may pay more universal service funds. But they'll be a big winner. TMRS providers have been a big winner in some of these areas.

The urban areas should be the big winners in this area. And contributing to universal service is an offset to that.

MR. POWELL: Thank you.

MR. KENNARD: Commissioner Furchtgott-Roth.

MR. FURCHTGOTT-ROTH: Thank you, Mr. Chairman. I'd like to follow up on a question that Commissioner Tristani asked about federal and state responsibilities under 254.

I would like to get your opinion specifically on how that applies to 254(h), which is rural health care and schools and libraries. Is there both a state and a federal responsibility for that, as well? I would just like to ask if any of the panelists have a different view than what they said about 254 generally.

MR. SMILEY: I think they are all intended to be a national fund supplemented by state.

MR. FURCHTGOTT-ROTH: Mr. Tauke.

MR. TAUKE: I think that there is a difference in the statute between schools and libraries in the high-cost fund. Clearly in both cases there is an anticipation of a partnership. I believe that in the case of the high-cost fund, and from what we've learned already from the schools and library fund, that there is a need for the Commission to just look at the political and legal risks.

And if you start moving into the intrastate funds, or monies, if you will, for purposes of collection, or if you use intrastate for purposes of allocation, it seems to us that you are opening yourselves to greater legal challenge. And that is a very serious problem.

I might just say parenthetically, we are concerned about the fact that the funding mechanism, the very Act itself, the funding mechanism in the Act is being challenged as an illegal tax in the courts. We are concerned that the administrative structure has been labelled by the GAO as illegal. We are concerned that politically there are challenges to all parts of universal service. And all of us have an interest in certainty.

So whatever you can do in order to sort of reduce the risk that this is going to be subject to legal and political challenge, the better off we are. And that's one of the reasons why we have concluded that you should focus on the money that is moving from one state to another in order to help the high-cost states, and try to collect those funds on the basis of interstate revenues.

MS. MANDEVILLE: Commissioner, I have not looked into the specific legalities of that question. I can tell you what Montana is doing.

We have a state small, what we call a universal access fund that picked up what we thought may be some gaps in the federal education and health care fund. It funds, for instance, tribal community colleges and some of the tribal schools that we thought might not be picked up. It specifically says it cannot duplicate the federal mechanisms. And that seemed like a good separation, and certainly within the intent of the Act.

MR. LUBIN: I don't have anything.

MR. FURCHTGOTT-ROTH: Two-fifty-four (h) specifically says that the discount shall be an amount that the Commission with respect to the interstate services, and the states with respect to the intrastate services, determines the appropriate and necessary. Mr. Tauke, if the discount for intrastate services is to be set by states, how is that done without a state collection of the funds?

And secondly, is internet access an interstate service?

MR. TAUKE: You are putting me on the spot. As you know, our company has tried to work with the Commission to establish a schools and library fund. And we've tried to support the Commission's efforts in that arena because of the desirability of the goal.

And having said that, however, I think it is clear that there are some statutory questions about some of the steps that have been taken. And some of those now are being aired out in the courts. We have not chosen to make those legal challenges, because we are trying to look at the larger good here.

But I do think that it is, the statute does seem to suggest fairly clearly, as you point out, that the states are the ones that would determine the discounts for intrastate services.

In our view, having made that point, I guess on the second question about what is the internet, our view essentially is that the internet is an interstate service. We wish the Commission would make that clear, parenthetically. However, as you know, I think about 17 states now have declared it an intrastate service for purposes of reciprocal compensation.

Somewhere along the line there has to be a clarification of what the jurisdiction is, or what classification should be provided to that service. And that may be done, not only for purposes of this, but for other purposes, as we go forward.

MR. FURCHTGOTT-ROTH: Does anyone else have any comments on those questions? Mr. Lubin?

MR. LUBIN: The comment that I have is simply a bottom line. And the bottom line is no matter how you cut it, when you have schools, libraries, or rural health care, and it's been cut back, with the expectation that it could rise, and it could rise a fair amount, and that a way to finesse the issue was to put it on intrastate and interstate, which made sense.

But when the Commission then, bottom line, says to the incumbent LEC, your assessment can be recovered back into the interstate jurisdiction. And when you look around in the interstate jurisdiction to see what tariffs are available, and they are only access tariffs. The bottom line is, even though we're recovering, we're assessing it on total revenues, the bottom line is that all -- not all, 93, 92 percent -- flows back into interstate access tariffs.

And so, for me, simply a bottom-line question is, I don't see that as competitively neutral. And somehow, some way, there has got to be a way to fix that. What we have said in various reports, to you and to Congress, is that the way to fix that -- and I think one of the Commissioners implied it this morning -- is simply you call it for what it is, and you put it on the bottom line of the bill. And, you know, you don't make it explicit here, and then funnel it into a tariff over there.

And by the way, when you do that, back to

Commissioner Powell's earlier question, there are competitive implications. Competitive implications with unbundled network elements or total service resale, and I won't bore you with all of that. But somehow, some way, that's got to get fixed, from my point of view.

Thank you.

MS. MANDEVILLE: Commissioner, I think that the internet problem points out the, I guess, ultimate inability to clearly distinguish between interstate and intrastate. Data shopping today is fairly blatant between jurisdictions.

I think states probably threw up their hands and said, "If it's not access, it must be local, so it's subject to reciprocal compensation." Not that they wouldn't like it to be access. But that is the fundamental problem that we will see with more and more services, if we try and make a clear distinction between interstate and intrastate.

MR. LUBIN: One other thing to your question, Commissioner, which I really didn't respond to. And that is, it's our position that we think the internet, with regard to telephony, should pay the assessment taxes, or the assessment rates for the various universal service funds.

Thank you, Mr. Chairman.

MR. KENNARD: Thank you, Commissioner.

Commissioner Ness.

MS. NESS: Thank you, Mr. Chairman. Mr. Tauke, I agree with you that regulatory certainty and certainty in all of these different intertwining areas is critical in order for us to get on with competition. You know, it's just crazy how all of these companies, in every single area, keep filing in court, including challenging as unconstitutional 271. But that's the way of life here. And it's a pity that that's the case, but that is the case, and we have to deal with it.

At times I figure that, I mean, I sort of feel like deja vu. I've been hearing these same arguments, and each time that we've done a forum it's been helpful, but it still goes round and round and round. Part of it is perhaps that the Act, in its eloquence, creates simultaneous equations, where some of the -- too many of the elements are defined. And thus, trying to put the pieces together makes it extremely difficult.

Having said that, I would like to go back a little bit to what was discussed in the first panel. And that was the ad hoc proposal. And see if any of you had thoughts with respect to the pros of such a proposal, and the negatives of such a proposal. Beginning with you, Mr. Tauke.

MR. TAUKE: I think this panel has highlighted one of the problems we have had in discussing the universal service issue.

A number of the participants I think have operated from the context that we are talking about the models. And we, at Bell Atlantic, spend a lot of time on models.

Our belief is, certainly my personal view is, you cannot come up with a model that is fair, equitable, and will withstand legal challenge.

And also, when you go back and read the Act, you don't need a model. And in fact, the models historically dated from pre-Act days. They were created for, they were being developed prior to the enactment of the Act to deal with the universal service system as it existed at that time.

So I would like to suggest, first, that we should ignore for a moment the models, and then try to figure out what the Act requires.

We believe that the Act suggests, as the ad hoc plan suggests, that the FCC, the national fund, focus on the transfer of monies between, or I should say among, the states, and not focus on the amount of money being given for a given company or a given wire center or a given customer. But the national fund should focus on the transfer of monies among the states.

Then the states would deal with the second layer of issues. So in that sense, I believe that our comments would be consistent with the comments of the ad hoc group.

The ad hoc group, I think, has, in determining what monies should go between the states, has looked at the models, and they looked at the existing system. That may be appropriate. I think that how you determine exactly what goes between the states is, in a sense, a somewhat arbitrary decision, although you have to have justification for it.

We believe a better approach is to use a mechanism, whether you use one of the models, a combination of the models, or data you already have on hand, but use some mechanism to get a fair and equitable assessment of costs. And the important thing here is the relative nature of the cost from state to state.

And if you determine that on an average basis, then you determine how much money has to flow from one state to another.

So I think that the basis of the model is correct. We would probably have some suggestions relating to details.

MS. NESS: If we were to go with the state-by-state approach, that's based on the costs as assessed by the state, where is the incentive for the state to cut down on costs? To squeeze out additional costs?

MR. TAUKE: I don't think you should rely on the states to make the cost assessment. Because obviously each state would have a huge incentive to inflate their costs in order to get more money out of the federal funds.

You do need some kind of a mechanism that would use the same standard for assessing costs in Vermont as they do in New York, in California as they do in Iowa. And so you need to get a common standard for assessing costs in order to have fairness and equity.

MS. NESS: Ms. Mandeville.

MS. MANDEVILLE: I would agree with the last points made there, that you may not be able to rely on that to cut costs.

I would also say that, just looking at it, it appears to say that your responsibility is to states and not to customers. And I think your responsibility under the Act is to customers.

If a state decides to take all that support and give it to US West, I don't think that my customers are going to let you off the hook.

I very much respect what they have tried to do. One of the key indications was this takes a great deal of compromise. I may sit here and agree with you to trade some of my universal service support for getting out a 251 mandate. I think anyone who came in and said, "I want a section 251 resale agreement," would say that you did not have the ability to negotiate that away.

And so I think that same thing exists. You don't have the ability to negotiate away the universal service requirements.

MS. NESS: Can you tell me how much, on average, your customers pay for basic telephone service?

MS. MANDEVILLE: It varies from a low in some of our small exchanges of about $10, up to a high of about $20 in some areas. And depending on how far out of town they are. We have some zone charges.

MS. NESS: Mr. Lubin.

MR. LUBIN: With regard to the ad hoc proposal, I only have a high-level knowledge base, so I can only comment relative to that.

But the significant concerns that I have with it are the concept that there is roughly about $600 million more needed. And it isn't clear to me why there should be $600 million. And again, it gets back to what level of disaggregation was used. So that, to me, is a big issue.

Conversely, if the plan were, and which I thought was the original plan, but I realized they are talking with a lot of different people and plans evolved, the original plan was it was roughly not an increase; it was roughly taking the existing dollars, and then redistributing them amongst the parties. That has a better attribute, from my point of view, especially if you remove the dollars, which is about $114 million for the existing major ILECs.

The second concern that I have is that, with the number that I heard this morning from Chairman Welch, the $600 million, my understanding is that is new money entering into the system, but would not be used to lower interstate access. It would presumably be used to lower intrastate rates, is my understanding. But not interstate access. And not necessarily intrastate access.

So, to me, that is a significant concern.

The third concern, which I will say, but I will also say I'm not totally sure, but at least some people have implied to me, that the money is not competitively neutral distributed. So I have one question, in terms of how does it get distributed amongst the parties; namely, the incumbents. But then the second question is, you know, is it competitively neutral if somebody else enters into the market. And if somebody knows the answer to that, I'd appreciate hearing it.

MS. NESS: I will go back to your first point. And I thought that Chairman Welch did an excellent job of pointing out that you can distinguish between disaggregating cost and disaggregating the price to the consumer. And that your point about not having deaveraged rates for unbundled elements is a very good one.

Mr. Smiley.

MR. SMILEY: Like Mr. Lubin, I have only a high-level knowledge of the ad hoc plan. But from what I understand, even the modest increase that they would see in the overall size seems, to me, to be short-sighted.

I think most of the money that today is in the fund goes to small companies. Interstate access provides about $18 billion in support. And if the new fund is created to the size of the old, then it seems to me that the FCC will not be able to reduce access charges to the way that they had intended. And --

MS. NESS: Mr. Smiley, can I ask you, have you deaveraged the cost of your unbundled network elements?

MR. SMILEY: As you know, we serve 14 different states. We have cost dockets in various proceedings. Some states have, and some have not. So it is a mix.

In Minnesota, we have not concluded the final cost docket. AT&T, for instance, has proposed nine separate zones. And the final decision is not in.

MS. NESS: But you would argue, though, that the cost does vary loop to loop, area to area.

MR. SMILEY: Yes, it does.

MS. NESS: And therefore, that you ought to be able to receive funds where the cost is greater in a particular area. Even though, if you look across all of those loops, the average for you might work out --

MR. SMILEY: Might be X.

MS. NESS: -- to be X.

MR. SMILEY: You know, I think the issue is that if you're going to get into a wholesale deaveraging, or deaveraging of loops, you also need to deaverage your prices at the same time. Because one without the other just won't work.

MS. NESS: Mr. Griffin.

MR. GRIFFIN: Well, as a wireless carrier, I would say I have not even a high-level understanding of the --

MS. NESS: Fair enough.

MR. GRIFFIN: -- ad hoc proposal. For which I can probably report that I'm pretty pleased.

I will say that just conceptually -- and we are, from the wireless perspective, we are looking at these things perhaps more broadly than some. To the extent that the ad hoc proposal is suggesting that there are new funds added to the total, it seems to me, as I said in my earlier remarks, that that goes beyond the concept of simply making implicit subsidies explicit. Because you clearly don't create a single new dollar by converting from implicit to explicit. And you have now quickly moved into a whole new area of regulation when you begin to add monies to the funds.

MS. NESS: It's a bit like a shell game, where you are trying to find where the pea is. And certainly, you are correct that if right now one can argue that there are affordable rates across the country, one would wonder, at the end of the day, why additional funds would be added. Maybe there needs to be a recalculation making some explicit less -- making funds explicit, but adding new funds will, has to certainly be justified, based on where we are.

I think my time has gone, and I think folks are probably going to be interested in going to lunch. So Mr. Chairman, let me pass it back to you.

MR. KENNARD: Okay. Thank you, Commissioner. I have outlined publicly some principles which I believe should govern reform of universal service.

And one of those principles calls for the states to reform their own universal service funding mechanisms as a condition to additional federal support.

And I'd like to know your views on that. And I'd like to start with you, Ms. Mandeville. Because I noticed in your testimony, you said that federal support cannot be conditioned on restructuring or reforming the intrastate system. And, one, I'd like additional comment from you on that.

And second, I'd like to know, from you and the other panelists, if you believe that there should be additional federal support to the intrastate jurisdiction. How can we incentivize the states to use that additional funding efficiently, and ensure that there is some reform at the state level before additional funding is made?

MS. MANDEVILLE: Mr. Chairman, we do believe that you cannot condition universal service support on state actions. In Montana it takes the Legislature to give the State Commission authority to do a universal service fund.

If the State Legislature chooses not to do that -- and they do have some temporary stopgap authority that sunsets at the beginning of '99. If they choose not to do that, then Montana simply would be without a universal service fund.

I think that doesn't say you can ignore the universal service mandates of the Act.

Having said that, we have great discussions going on in the state about a state universal service fund, and pricing reform, not having to do with what you are doing, but having to do with state needs. We have state carrier common-line charges. We have margins built into state carrier access rates. We have business and residence rates that probably won't work long-term. And if anyone comes into one of our exchanges and takes your five biggest business customers, you better be able to deaverage your rates within an exchange.

I think the market is going to solve most of those questions. As I mentioned, my company is becoming a competitive carrier in Missoula. I think that those actions will start driving those price structures to cost, having nothing to do with where the statutes are, but having simply to do with how the market works.

MR. KENNARD: Well, putting the legal issue aside, some incentive from the federal jurisdiction to accelerate reform, wouldn't that be a good thing in accelerating a state action to reform universal service?

MS. MANDEVILLE: I think there is incentive to reform state charges, if the interstate charges change. It is definitely not in Montana's best interest to have carrier access rates that are two or three times as high as the interstate rates. What that does is it drives carriers out of the state, it drives carriers to be perhaps less than totally accurate with their usage that they tell us is intrastate versus interstate. And it creates some real problems with us.

We cannot explain to people in Montana why it costs more to call 90 miles across the state than it costs to call New York. Those do create immediate customer incentives to do things with the state structure. And we are very sensitive to that.

We have tried to bring our carrier access rates down to interstate levels, and have actually accomplished that, to make sure that those kinds of arbitrage abilities are not there.

MR. KENNARD: Do you have any sense of how long it would take for a state like Montana to move from an implicit subsidy system to an explicit subsidy system? It is a tough question; I won't hold you to a precise --

MS. MANDEVILLE: It's a tough question. And typically the states have not done as many transitions as the federal jurisdiction has. I would hope that they would look at transitions in this kind of a really major restructuring. You know, theoretically, it could happen in a year.

There are so many large winners and losers in a total restructuring that I think the state will probably be somewhat cautious and try and do it as competition develops.

MR. KENNARD: Anyone else care to comment? Mr. Lubin?

MR. LUBIN: My reaction is that, when I read those principles, for me, anyway, it was a paradigm shift, a little bit. A little bit. And I saw potential merit. But what was driving me, in terms of trying to figure out how this would work, was the economic incentives.

And I was trying to figure out, is there a way to create an economic incentive for the state to do what you want, but not to gain the system that says, hey, this system over here is going to try and figure out to do it in such a way -- follow all the rules, follow all your criteria that you laid out -- but do it in such a way to drive more costs into the federal jurisdiction.

So the question -- and to me, it is kind of what you just asked -- is, is there a way to create the economic incentive to do what you suggested without creating the opportunity to do more cost into the interstate.

The other thing I had observed, and it's why, quite candidly, I think, at least from my perspective, there is some, it's worth investigating, is that there are some states that are looking at this very question. And when they look at it, they are looking at it -- and maybe it's because they have one unbundled loop in the state, I don't know why. But they're looking at it, and saying, okay, I'll use these proxy tools. And then they look at the revenue generated. And what they say is, you know what, I don't need a universal service. I've got enough here without having explicit fund. And by the way, some of the states do that, and don't include access. Some do include access.

So my point is, that's an interesting one, because that state may come along and say, hey, I don't need a lot of dollars, or maybe it's very small. And if that state were to do that, what would they do at the federal level, because that would assume that they don't need anything at the federal level.

But anyway, my bottom line to you is, you know, what we've been trying to do is take the principles and say, is there a way to create an economic incentive to eliminate the concern that I articulated.

MR. KENNARD: Mr. Tauke.

MR. TAUKE: First, I do think that you do have the ability to place some conditions on the distribution of dollars that would come from a federal fund to states. And I think, as a matter of judgment, you would probably want to give the states some time to react to that. So I'm not sure that you should require them to meet it immediately.

But one of the reasons that you may want to consider doing that is because I think there is also a need to have a general sense among the public that this is a fair system. And whether it is accurate or not, I think there is some perception now that the universal service system isn't fair.

In some of our "lowest-cost" states, in places like Baltimore and Buffalo and Boston, we have telephone rates for basic telephone service that are higher than many of the rates mentioned this morning, that are -- and we are, in essence, asking our customers to pay a little more to send the money to those places that are now paying substantially less.

Now, part of the reason for that is because the way in which prices have been structured. But what has been happening in our larger, lower-cost, and ironically, or I should say not surprisingly more competitive states, is that the access rates have been coming down. And as we go to one-plus dialing, the intrastate toll rates are coming down. And that has meant there has been some relative increase in the dial tone rates.

But it is hard to explain to people in Boston who are paying $19 a month, or Buffalo who are paying $30 a month for telephone service, why it is that they are going to send more or pay more in order to send money to people who are paying eight or nine dollars a month for telephone service.

And so I think having some, you know, effort here to encourage the -- a different pricing model in some cases, or taking other steps would be helpful in -- subsidies out of the rates, and to move this toward the competitive model.

I am very uncertain. As a matter of fact, I think I would be almost oppositional to providing some sort of a federal hurdle that they must go through if that's what the suggestion is, similar to what is being done on a 271 basis today. And I'm not sure exactly, you know, I don't have all the specifics exactly of what's behind your eight principles.

But to me, qualifications for added federal support I think ought to be clear to the states today. It ought to be a national fund today. And we ought not set up an additional federal process to have states go through to qualify for that, for that support.

MR. KENNARD: Well, I see that we have gone almost an hour over our time this morning. And I think that that's a result of the -- not only how interesting these issues are, but the quality of the panelist we had today.

So I wanted to thank you all for being here today. And unless there are any closing comments from the bench -- okay, very good.

MS. TRISTANI: I talked at the beginning of how wonderful, how important universal service is. And how this country is in an enviable position.

We have 94-percent telephone penetration. You all know that. But you know, we're not there yet. In my state of New Mexico, it's about 87 percent. In Puerto Rico, which is a territory in part of the United States, it's about 74 percent. And those of you that know the states that have large Native American reservations, know that on some of their reservations it varies between 30 and 50 percent.

So we're not there yet, with universal service for all Americans.

I wanted to remind us all of that. And stress again that I think it's very, very, very critical that this Commission makes sure that whatever we do at the end of the day doesn't make any American get off the network.

Thank you.

MR. KENNARD: Thank you, Commissioner. Well said. With that, I'd like to again thank our panelists, and also thank the hard-working FCC staff that put together this panel today. Lisa Gelb, Melissa Waxman, Jonathan Raydin, Cheryl Todd, Chuck Keller, Maureen Peritino, Rivera Marshall, Pam Gallant, Macauley Sallas, and of course Richard Metzger and Bob Pepper. Thank you all very much for being here.

And these issues obviously are of great importance to this Commission and the country. And you have my commitment that we will continue to focus on them and get them resolved very, very quickly. Thank you.

(Whereupon, at 11:53 a.m., the hearing was concluded.)

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HEARING DATE: March 6, 1998

LOCATION: Washington, D.C.

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