

equipment over the life of the switch and not at a particular point in the switch's life cycle. In addressing this question, parties should explain the assumptions they make with respect to line demand and technology improvements, and their assumptions regarding vendor pricing strategies.

22. The basic formula for developing a price for an element is to divide total cost by total demand. We ask for comment on the use of this principle in developing a price that is based on costs of equipment installed in increments over the life of the switch. Parties should also explain whether, and how, these calculations should account for the time value of money. Is the appropriate discount rate for use in determining the time value of money the cost of capital used in calculating UNE prices generally?

23. Assuming that unbundled switching prices should reflect vendor prices for switch equipment that is installed in increments over the life of the switch, we seek comment on whether the starting point for calculating costs should be a new switch that is installed today. We also seek comment on whether unbundled switching prices should reflect, in addition to costs for the initial switch equipment, costs of growth additions and technology upgrades, growth additions alone, or upgrades alone for the years following the initial installation. Commenters that believe current prices should recover costs of future upgrades should explain why current competitive LECs should pay for benefits that they do not yet receive. In light of our conclusion that UNE pricing should continue to be based on a forward-looking methodology, we ask commenters to describe in detail any rationale for supporting or rejecting UNE prices based on vendor prices that incumbent LECs currently pay for equipment they are installing today in existing switches.

24. We ask parties to explain in detail the methodology that should be used to develop total cost and total demand under this approach. We also invite parties to submit studies showing how to develop an unbundled switching price. These studies should assume that service is provided using modern digital switches that are installed today. We ask that commenters develop this price for either an incumbent LEC's study area or a UNE zone within a study area. One study should develop the costs of initial new equipment and all future growth equipment that is expected to be installed periodically over the life of the switch. A second study should develop costs for these two components plus

costs of all future technology upgrade equipment that is expected to be installed periodically over the life of the switch. Parties should explain and fully document the methodology, assumptions, and data they use to estimate these costs and the demand over which these costs are spread. If a commenter believes UNE prices should be based on a switch technology other than digital technology, that party may submit other studies in addition to, rather than in place of, the studies requested above.

25. *Cost of Capital.* The cost of capital is the cost a firm will incur in raising funds in a competitive capital market. It is generally estimated as a weighted average of the cost of equity and the cost of debt. In the *Triennial Review Order*, the Commission clarified that the TELRIC-based cost of capital should reflect the risks of a competitive market. Because the objective of TELRIC is to establish a price that replicates the price that would exist in a market in which there is facilities-based competition, the Commission held that TELRIC prices should reflect the risk of losing customers to other facilities-based carriers. The importance of this clarification was to confirm that state commission must use a consistent set of assumptions when they calculate the three main rate components (*i.e.*, operating expenses, cost of capital, and depreciation). We invite parties to comment on whether this principle should apply even if the Commission adopts a UNE pricing methodology that is tied more closely to the existing network of an incumbent LEC.

26. We ask parties to identify the specific variables that determine the cost of capital under the network assumptions that they advocate, and to offer suggestions as to how to quantify the various components of risk that should be reflected in a company's cost of capital. We request parties to identify both the theoretical arguments and empirical evidence supporting the use of these variables. We seek comment on how the cost of debt and equity should be weighted and on how states should determine the appropriate capital structure. We seek comment on whether incremental investment is typically funded through debt or equity and whether the cost of capital should reflect this.

27. One important risk factor is the risk of losing customers to facilities-based competitors. How should this risk be measured? What is the relationship between this risk and the network assumptions we adopt. Is the risk of supplying a product or service always greater in a competitive market than in

a monopoly market? We also seek comment on the role of fixed and sunk costs, assumptions about the level and kind of competition, and entry strategies of competitors in affect risk and cost of capital of incumbent carriers.

28. We seek comment on the relationship, if any, between our unbundling rules and the risk of stranded investment. Have long-term contracts been used in the provision of UNEs and how does this answer affect the cost of capital? How can the risks associated with month-to-month contracts be quantified? Does the use of economic depreciation eliminate the need to compensate separately an incumbent LEC for any additional risk of stranded investment?

29. We ask parties to comment on ways in which the Commission might simplify the task of setting the cost of capital. For example, if we retain our current rules, should the cost of capital vary among different states or among different companies, and, if not, should the Commission establish a particular cost of capital for states to employ? If we move to a pricing regime that looks more closely at the incumbent LEC's actual network, are there any presumptions we could establish to facilitate selection of a cost of capital? We ask parties to provide studies in support of their proposals. Regardless of our network assumptions, are there particular models for projecting cost of capital that should or should not be used and are there particular data sources that should or should not be given deference? We ask parties to identify proxy companies or industries for use in estimating UNE cost of capital.

30. We ask parties to comment on when it would be appropriate for a state commission to establish different costs of capital for different UNEs and, in those situations, to identify what types of risks distinguish one element from another. Would such an approach accurately reflect how incumbent LECs actually raise capital and, if not, is this relevant? We also seek comment on why such an approach has not been implemented in the states. We seek comment, particularly from state commissions, on whether and, if so, why such an approach has been considered and rejected. Are there steps the Commission could take to facilitate the ability of states to establish UNE-specific costs of capital? Do the benefits of using a cost of capital that more accurately reflects the risk associated with providing a particular UNE outweigh the administrative burden of such an approach?