

**Q. In its Statement of Position, the Company points to deficiencies in the TSLRIC approach and proposes and defends use of a variant of the efficient component pricing rule (ECPR) to set unbundled element prices as well as wholesale prices. Is this an appropriate rule to employ here?**

A. While I agree with the Company that element prices for competitors set at TSLRIC may not provide sufficient compensation for the incumbent, I have serious reservations about the Company's proposed use of the ECPR. Admittedly, provision must be made for recovery of joint and common costs. However, in the context of network elements, the magnitude of these costs is less than in the context of retail services. Furthermore, the FCC's TELRIC concept can be interpreted and implemented to nearly equal the average total cost of producing each network element on a stand-alone basis. To that extent, no additional allowance for joint and common costs would be necessary in order for the firm to recover its total cost of producing each element.

**Q. What has the FCC had to say about ECPR as a pricing mechanism for unbundled elements?**

A. The ECPR was rejected by the FCC in its *Interconnection Order*. The FCC found as follows:

We conclude that ECPR is an improper method for setting prices of interconnection and unbundled network elements because the existing retail prices that would be used to compute incremental opportunity costs under ECPR are not cost-based. Moreover, the ECPR does not provide any mechanism for moving prices towards competitive levels; it simply takes prices as given. The record indicates that both incumbents and new entrants agree that retail prices are not based on costs. Incumbents generally argue that local residential retail prices are below costs while new entrants contend that they exceed competitive levels. In either case, application of ECPR would result in input prices that would be either higher or lower than those which would be generated in a competitive market and would not lead to efficient retail pricing. [para. 709.]

In fact, one of the originators of the concept, William J. Baumol, has concluded that ECPR is NOT an appropriate pricing rule for unbundled elements. [Affidavit of William J.

Baumol, Janusz A. Ordover, and Robert D. Willig, for AT&T, May 16, 1996, CC Docket No 96-89.] Other economists are also dubious about the validity of ECPR in this context. For instance, in a recent study published by NRRI, David Gabel argues that if retail rates reflect inefficiencies or monopoly profits, ECPR will not lead to efficient prices. [Competition-Enhancing Costing and Pricing Standards for Telecommunications Interconnection, NRRI, David Gable, September 1996, p. 41.]

**Q. In a North Carolina proceeding (GTE Arbitration Dockets P-140, Sub 51 and P-141, Sub 30), a GTE witness, Dr. David S. Sibley, claimed that GTE's version of ECPR avoids the problems of the original version. Are you familiar with this variation?**

A. Yes. I have reviewed descriptions of this variation, called the Market-Determined Efficient Component-Pricing Rule (M-ECPR). In my opinion, the major objections to the "rule" remain. The use of M-ECPR could result in prices close to the stand-alone cost for provision of these elements on a network which does not enjoy the full benefits of economies of scale and scope. Thus, the M-ECPR approach can yield prices which approach the extreme upper bound of viability (the cost of self-provision by a competitor). Under the M-ECPR approach, unless a competitor can construct a network element more cheaply than the incumbent LEC's unbundled element rate, that rate would not decline, regardless of technological improvements, increased economies of scale, or other factors that would lead to price reductions in a competitive wholesale market. Stated differently, there would be a tendency for the unbundled element rate to be set at relatively high levels, constrained only by the cost of self-provision by competing carriers. In market areas where facilities-based competition isn't practical, the unbundled elements could be priced so high that retail competition would be discouraged or precluded.

Of course, the actual prices proposed by the Company may not be as high as the M-ECPR theory could justify. In other words, while the Company's position could potentially result in extremely high rates, the Company may not fully implement the theory in the actual rates it will be proposing in this proceeding. However, the risk of high rates would remain.

**Q. Do you see any other problems with the M-ECPR?**

A. Yes. Another serious concern is that the M-ECPR approach effectively requires highly detailed analysis of the costs of, and revenues generated by, the entire network in order to price any single element. It is potentially far more complex than the FCC's bottom-up TELRIC approach, and arguably is a backdoor method of pricing based upon embedded costs (since the element prices will be tightly linked to retail prices, which are going to remain for some time largely based upon the rate base, rate of return legacy). Whether or not this is legally permissible, it certainly isn't a straightforward application of the language of TA96 in §252(d).

While the proponents of ECPR approaches may argue that the language of the Act is vague enough to allow consideration of "opportunity costs," the M-ECPR approach effectively backs into a price from the prevailing level of retail rates. If Congress had intended to set unbundled element rates in this "top down" manner, it could have more clearly specified its intent, as it did in the section of the law dealing with the wholesale pricing of bundled services.