

REGULATION, COMPETITION, AND THE OPTIMAL RECOVERY OF  
STRANDED COSTS \*

by

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ABSTRACT

The emergence of competition in traditional public utility industries has given rise to a number of challenges to both positive and normative theories of regulation. Perhaps none created more controversy than the debate regarding embedded cost recovery once a regulated monopoly is opened to competition. Of particular concern is the prospect that embedded costs that have been incurred in a monopoly environment will be unrecoverable (i.e., stranded) in a competitive environment. In this paper, we develop a model of the socially optimal level of stranded cost recovery for a regulated firm facing the prospect of competition for its services under the assumption that past actions by the firm and regulators were rational. Some very useful generalizations emerge from the analysis. Among these, perhaps the most important is that under reasonable assumptions full recovery of a firm's costs that are stranded by competition is not generally socially optimal.

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