BOARD STAFF INTERROGATORY #11

INTERROGATORY

Reference: p.1, lines 22-25

Preamble: "As a consequence, allowing customers to choose an alternate distributor, where doing so would strand some portion of the distribution network or the incumbent distributor without compensation, would not be efficient."

Could the provision of compensation by the applicant to the incumbent remove this inefficiency?

RESPONSE

Compensation is not strictly necessary to ensure efficient decisions. All that is necessary is that the service provider with the lowest incremental costs be the preferred service provider.

In a fully competitive market, competition would tend to produce the efficient result without compensation. Hence, a new entrant can attract business from another firm and effectively strand its investment in production facilities, retail space, etc. without compensation. Economic efficiency is achieved without compensation for stranded assets.

In a regulatory environment in which stranded costs are passed through to customers, which is not the case in fully competitive markets, compensation is needed to ensure that the price signals faced by market players are correct. Compensation is needed to "internalize" all of the cost consequences of each alternative.

The issue of compensation also arises because of certain characteristics of the regulatory environment. Compensation is relevant for the following reasons.

1. Assuming the incumbent is able to recover all of its costs from its remaining customers, costs will be shifted to "captive" customers if there is no compensation for stranded assets. In a competitive market, the shareholder bears the burden of stranded costs if its costs are higher than those if its competitors.

2. In the absence of compensation for stranded assets, an incumbent would have to price competitively where customers have access to alternate service providers. Not only would this defeat the policy of postage stamp rates, it would result in shifting of costs to more "captive" customers even where the incumbent is able to retain those customers with competitive alternatives.

3. Regulators tend to be reluctant to require shareholders to bear the burden of stranded assets where incumbent service providers are not competitive with alternate service providers, particularly where competition is introduced as a policy that alters the traditional regulatory compact.