PRINCIPLES OF UTILITY CORPORATE FINANCE

Leonardo R. Giacchino, Ph.D.

Jonathan A. Lesser, Ph.D.

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CHAPTER 2
REGULATORY CONCEPTS

2.1 Introduction

The principles of corporate finance apply to all companies and industries. However, every industry has idiosyncratic features that need to be taken into account when using these principles in financial analysis. In the case of regulated utilities, prices are determined by a regulator and not by supply and demand conditions (which ordinarily determine prices for companies that operate in unregulated markets).

Rate regulation imposes limits and restrictions that have financial impacts on utilities. For example, if two jurisdictions have utilities with the same portfolio of generating plants but apply different rules about how to recover the costs of those generating plants, one region will likely have higher electricity prices than the other.

Corporate finance principles must be applied differently to regulated and unregulated companies. If they are not, in analyzing a regulated company, faulty decisions can result. For example, regulators might require a utility defer the collection of some revenues to the following year; this would affect the utility's short-term cash flow. The financial ratios for the utility might show lack of liquidity, and the situation would disappear in the next period when the utility would collect those deferred revenues. In the case of an unregulated company, this simply would not happen.

To understand how the principles of corporate finance apply to utilities, we need to consider the regulatory environments in which these companies operate and, more specifically, we need to understand the regulatory concepts that come into play in those environments.

2.2 Goals of Regulation

The underlying economic concepts of utility regulation are easily obfuscated by myriad state and federal regulatory proceedings, legislative rules, and court decisions. Yet, despite the complexities of regulation, these concepts are relatively simple; it is their *application* that can be difficult.

The fundamental economic goal of regulation is straightforward: to mimic a competitive market outcome, even when the underlying market is not competitive. In other words, purely economic regulation strives to achieve outcomes that capture the benefits of purely competitive markets when those markets are themselves not competitive.

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