

Table of Contents

Preface	xvii
PART I: CONCEPTS	1
Chapter 1: Why Utility Corporate Finance?	3
1.1 What is Corporate Finance?	4
1.2 Utility Corporate Finance Defined.	4
Chapter 2: Regulatory Concepts	7
2.1 Introduction	7
2.2 Goals of Regulation.	7
2.3 The Revenue Requirement.	8
2.4 Basic Concepts of Utility Regulation	11
2.5 Regulatory Regimes	15
2.6 Other Regulatory Concepts	22
2.7 Chapter Summary	26
Chapter 3: Review of Mathematical and Financial Concepts	27
3.1 Introduction	27
3.2 The Opportunity Cost of Capital.	27
3.3 Multiperiod Cash Flows	32
3.4 Geometric and Arithmetic Means.	38
3.5 Cost Levelization	41
3.6 The Internal Rate of Return	45
3.7 Measuring Risk	50
3.8 Chapter Summary	51
3.9 Appendix: Derivations of Key Formulas	52
Chapter 4: Financing Regulated Utilities	55
4.1 Introduction	55
4.2 Financial Instruments	55
4.3 Valuing Stocks.	65
4.4 Valuing Bonds.	69
4.5 The Weighted Average Cost of Capital	72
4.6 Does Capital Structure Matter?	75
4.7 Chapter Summary	82
Chapter 5: Key Concepts of Regulatory Accounting	83
5.1 Introduction	83
5.2 The Three Sets of Regulated Company Books	84
5.3 Regulatory Accounting.	85
5.4 Usefulness of Regulatory Accounting	86

5.5	Ring-fencing	88
5.6	Presentation of Information	88
5.7	Specific Differences Between Traditional and Regulatory Accounting	90
5.8	Chapter Summary	95
Chapter 6: Measures of Financial Performance and Risk		97
6.1	Introduction	97
6.2	Evaluating the Financial Statement of an Electric Distribution Company	97
6.3	Liquidity Ratios	100
6.4	Leverage Ratios	104
6.5	Coverage Ratios	107
6.6	Efficiency Ratios	109
6.7	Profitability Ratios	113
6.8	Market Value Ratios	118
6.9	Risk Analysis Ratios	120
6.10	Other Ratios	122
6.11	Chapter Summary	122
Chapter 7: Measures of Costs and Their Application		123
7.1	Introduction	123
7.2	Accounting and Economic Costs	123
7.3	Measuring the Cost (and Value) of Capital Assets	124
7.4	Capitalized and Expensed Costs	126
7.5	A Smorgasbord of Cost Categories	129
7.6	Benchmarking Costs	132
7.7	Chapter Summary	134
Chapter 8: A Primer on Setting Regulated Utility Rates		135
8.1	Introduction	135
8.2	The Five-step Process	135
8.3	The Revenue Requirement and Its Components	137
8.4	Cost Functionalization	143
8.5	Cost Classification	144
8.6	Cost Allocation	144
8.7	Rate and Tariff Design Concepts	146
8.8	Introduction to Incentive Regulation Concepts	154
8.9	Chapter Summary	163
PART II: RISK, REGULATION, AND THE COST OF CAPITAL		165
Chapter 9: Comparable Risk		167
9.1	Introduction	167
9.2	Defining Comparable Risk	168
9.3	Regulated Utility Applications	178

9.4	Comparable Risk and “Incentive” Regulation . . . . .	.182
9.5	Chapter Summary . . . . .	.183
Chapter 10: Defining and Measuring Risk . . . . .		.185
10.1	Introduction . . . . .	.185
10.2	Defining Risk . . . . .	.186
10.3	The Dimensions of Risk . . . . .	.186
10.4	The Types of Risks Regulated Firms Face . . . . .	.188
10.5	Measuring Financial Risk . . . . .	.190
10.6	Volatility . . . . .	.199
10.7	Introduction to Portfolio Risk: The Two-asset Case . . . . .	.204
10.8	Chapter Summary . . . . .	.214
10.9	Appendix: How Diversification Affects Individual Asset Risk . . . . .	.214
Chapter 11: The Capital Asset Pricing Model . . . . .		.217
11.1	Introduction . . . . .	.217
11.2	Deriving the CAPM . . . . .	.218
11.3	Interpreting the CAPM . . . . .	.221
11.4	Estimating Beta Values . . . . .	.224
11.5	How and Why Raw Betas are Adjusted . . . . .	.226
11.6	Leveraged and Unleveraged Betas . . . . .	.229
11.7	Determining the Market-risk Premium and the Risk-free Rate . . . . .	.232
11.8	An Application . . . . .	.237
11.9	The CAPM and Firm Size . . . . .	.239
11.10	Extensions of the CAPM—and Their Use . . . . .	.240
11.11	Chapter Summary . . . . .	.244
Chapter 12: Discounted Cash Flow Models to Estimate Return on Equity . . . . .		.245
12.1	Introduction . . . . .	.245
12.2	The Dividend Growth Model . . . . .	.245
12.3	The Quarterly DCF Model . . . . .	.248
12.4	The Efficient Markets Hypothesis . . . . .	.250
12.5	The DCF Model in Practice—Input Issues . . . . .	.251
12.6	The Sustainable Growth Rate . . . . .	.254
12.7	Multi-stage DCF Models . . . . .	.256
12.8	Dealing with Flotation Costs . . . . .	.258
12.9	Chapter Summary . . . . .	.261
Chapter 13: Capital Structure and the WACC . . . . .		.263
13.1	Introduction . . . . .	.263
13.2	Hypothetical vs. Actual Capital Structure . . . . .	.264
13.3	Adjustments Regulators Make to the WACC . . . . .	.267
13.4	Chapter Summary . . . . .	.271

Chapter 14: Estimating the Cost of Capital in Emerging Markets . . . . .	.273
14.1 Introduction . . . . .	.273
14.2 Objective Rules are Important. . . . .	.273
14.3 Selecting Comparable Firms. . . . .	.274
14.4 Capital Structure in Emerging Markets. . . . .	.276
14.5 Estimating Betas in Emerging Markets . . . . .	.277
14.6 Estimating Country Risk Premiums. . . . .	.280
14.7 An Example . . . . .	.283
14.8 Chapter Summary . . . . .	.287
PART III: FINANCIAL MANAGEMENT.	289
Chapter 15: Options, Derivatives, and Risk Management . . . . .	.293
15.1 Introduction . . . . .	.293
15.2 Forward and Futures Contracts . . . . .	.294
15.3 Call and Put Options . . . . .	.301
15.4 Hedging or Speculation? How Regulated Utilities Use Options. . . . .	.305
15.5 How Options are Priced . . . . .	.307
15.6 The Black-Scholes Options Pricing Model . . . . .	.312
15.7 Real Options . . . . .	.316
15.8 Chapter Summary . . . . .	.322
Chapter 16: Interest and Exchange Rates . . . . .	.323
16.1 Introduction . . . . .	.323
16.2 Types of Interest Rates . . . . .	.323
16.3 Monetary Policy and Its Effects on Interest Rates. . . . .	.325
16.4 The Term Structure of Interest Rates . . . . .	.329
16.5 Raising Debt by Utilities . . . . .	.336
16.6 Determining Exchange Rates . . . . .	.341
16.7 Chapter Summary . . . . .	.348
Chapter 17: Utility Capital Budgeting . . . . .	.349
17.1 Introduction . . . . .	.349
17.2 Basic Tools: NPV and Other Decision Criteria . . . . .	.350
17.3 How Utilities Use Capital Budgeting Tools. . . . .	.356
17.4 Choosing the Right Discount Rate . . . . .	.362
17.5 Making Investment Decisions When Capital is Limited . . . . .	.369
17.6 Avoided Costs and “Lumpy” Investments . . . . .	.376
17.7 Application: Aging Capital Assets . . . . .	.380
17.8 Application: Integrated Resource Planning . . . . .	.383
17.9 Chapter Summary . . . . .	.384
Chapter 18: Asset and Business Valuation. . . . .	.387
18.1 Introduction . . . . .	.387

18.2	Valuation Approaches	387
18.3	The DCF Method in Detail	391
18.4	DCF for Tariff Purposes	396
18.5	Presentation of Valuation Results	404
18.6	Chapter Summary	405
Chapter 19: Valuing Energy Contracts		407
19.1	Introduction	407
19.2	Mark-to-market Accounting	407
19.3	Valuing Regulated Electric Services	412
19.4	Energy Supply Contracts	416
19.5	Valuing Electric Transmission	423
19.6	Valuing Natural Gas Transportation Contracts	428
19.7	Risk Management	433
19.8	Application: Estimating the Option Value of a Power Purchase Agreement	434
19.9	Chapter Summary	437
19.10	Appendix: Sarbanes-Oxley Act	437
Chapter 20: Selected Application of Valuation Techniques		439
20.1	Introduction	439
20.2	Choice of Technology	439
20.3	Valuing Power Plants	444
20.4	Peaker Method	446
20.5	Valuing Natural Gas Reserves	452
20.6	Due Diligence and Fairness Opinions	455
20.7	Chapter Summary	456
20.8	Appendix: Constructing a <i>Pro-forma</i> Model	457
PART IV: FINANCIAL OPERATIONS ISSUES		459
Chapter 21: The Uniform System of Accounts		461
21.1	Introduction	461
21.2	Role of Accounting Standards	461
21.3	Financial Accounting Standards Board (FASB)	462
21.4	FERC and NARUC	463
21.5	International Accounting Standards Board (IASB)	465
21.6	Differences Between U.S. GAAP and IFRS	467
21.7	Regulated and Unregulated Activities	468
21.8	Application: Creating a Regulatory Accounting System for South Africa's Oil Industry	471
21.9	Chapter Summary	472
21.10	Appendix: How to Read a Regulated Utility Annual Report	472
Chapter 22: Key Utility Accounts: Concepts and Applications		475
22.1	Introduction	475

22.2	The Uniform System of Accounts	475
22.3	Treatment of Utility Assets.	483
22.4	Construction Work in Progress	485
22.5	Regulatory Assets.	488
22.6	Working Capital Allowances.	491
22.7	Expenses.	492
22.8	Taxes	496
22.9	Chapter Summary	499
Chapter 23: Depreciation		501
23.1	Introduction	501
23.2	What is Depreciation?	501
23.3	Estimating Average Life	503
23.4	Depreciation Mechanics to Set the Revenue Requirement	504
23.5	Actuarial Methods	506
23.6	Economic Life	510
23.7	Depreciation and Tax Normalization	512
23.8	Application: Sinking Funds and Nuclear Plant Decommissioning Costs	516
23.9	Chapter Summary	520
Chapter 24: Tariff-making		521
24.1	Introduction	521
24.2	Basic Information Needed for a Tariff Review	522
24.3	Case Study: Rate Design for an Electric Utility.	523
24.4	Accounting for Inflation	539
24.5	Chapter Summary	544
24.6	Appendix: Inflation Adjustment Formula	545
Chapter 25: Selected Topics		547
25.1	Introduction	547
25.2	Insolvency	547
25.3	Bankruptcy	550
25.4	Mergers, Acquisitions, and Divestitures	556
25.5	Chapter Summary	567
Bibliography		569
Index.		585