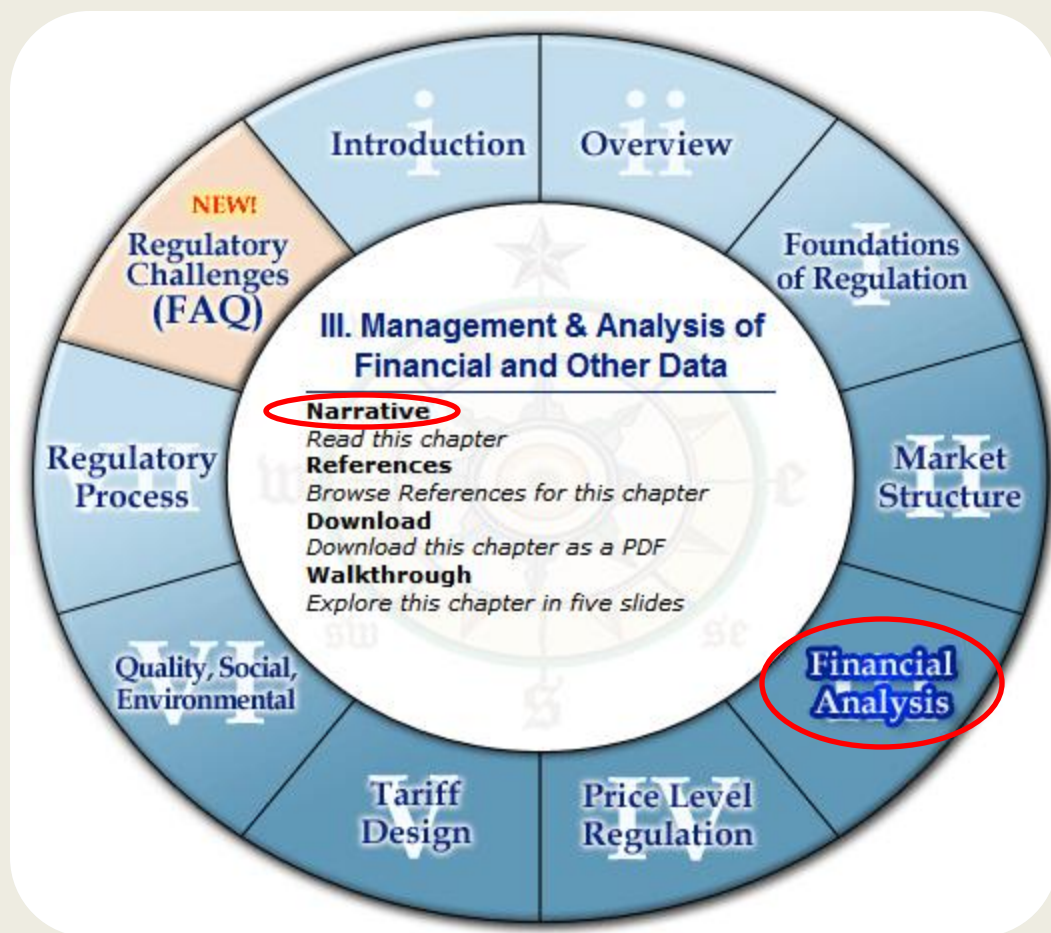


# Financial Analysis

The Body of Knowledge on Infrastructure Regulation is divided into seven main sections. Chapter III is dedicated to issues dealing with **Financial Analysis**.



Regulators use incentive regulation primarily to regulate the overall price level of the operator.

Financial analysis assists the regulator in gathering information on the operator and the market by providing the regulator with information on how various price levels affect the operator's ability to obtain capital for investment.

# How This Section Is Structured

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The BoKIR first examines Information in the Regulatory Process. The first step in decreasing the information asymmetry between the government and the operator is to identify the kinds of information that the regulator needs. Information availability determines what regulatory instruments can actually be used.

It then covers Regulation of Financial Statements. Two systems for controlling how an operator reports its financial results, USOA and accounting separations are described and information on when to use them is provided.

It then examines Comparative Analyses. There are at least two situations where the regulator may want to gather information from other jurisdictions, such as other countries. Agencies that regulate operators that serve multiple jurisdictions may find it beneficial to develop uniform reporting requirements and to share data. Also, information from other jurisdictions may be useful for benchmarking analyses.

Next, Earnings Measurement is discussed. There are two components of this analysis. The first component is earnings assessment, which identifies the received rate of return on the regulated operations. The second component is the measurement of the cost of capital. Some forms of regulation, such as pure price cap regulation, do not rely on operator accounting information for establishing overall price levels, so earnings assessments and estimates of the cost of capital are unnecessary in these situations. This section includes subsections on how to determine the earnings of the operator's regulated operations and with information on how regulation interacts with earnings.

Cost of capital is examined next. To assess whether the rate of return the operator is able to receive is sufficient to attract investor capital, the regulator must determine operator's cost of capital. Generally the cost of capital is estimated as the weighted average cost of capital (WACC), which is a weighted average of the operator's cost of debt and cost of equity.

Next, the BoKIR examines Business Decision Making and its Financial Effects. Examining concepts such as net present value, financial statements, and depreciation, while briefly describing why these are of interest for different types of regulation.

Finally, the topic of information management is addressed. Once the information needs have been defined, the regulator needs to establish how the information will be gathered and managed.

# Overall Conclusions

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The financial information provided by the operator reflects the extent to which the operator is willing to show the regulator how efficiently it can operate. The operator's innate ability to be efficient and the amount of effort the operator exerts to be efficient are called private or hidden information because the regulator cannot observe it. The regulator often tries to peer into this hidden information by collecting financial information, conducting prudency reviews, and performing management audits, but these approaches involve second-guessing the operator and require the regulator to become somewhat of an expert on managing an operator.

To overcome the dangers that exist when the regulator relies only on his ability to overcome information asymmetries through information gathering, the regulator generally adopts some form of incentive regulation, which rewards the operator with the opportunity to keep extra profits if the operator reveals its ability to operate efficiently, exerts the optimal amount of effort to be efficient, or both. Chapter IV on Regulating Overall Price Level examines these incentive techniques.

# References

The principal resource featured in the BoKIR is the list of (and access to) references that is provided under each section. The literature includes decisions and publications by regulatory agencies and other governmental bodies; policy advisories by think tanks, consultants, donor agencies, etc.; and research by academics, consultants, and other experts.

In the Financial Analysis section, references are organized under the following categories:

- Financial Analysis
  - Case Studies
  - NPV Concepts – Project Analysis and Risk Adjustments
  - Ratio Analysis
- Identifying Information Requirements
- Basic Financial Statements
- Regulatory System of Accounts
- Ring Fencing and Control of Cross-Subsidies
- Earnings Measurement
  - Case Studies
  - Asset valuation techniques
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  - Treatment of investment in price controls and the development of the rate base
  - Taxation
- Determining of Cost of Capital
- Financing and Risk Mitigation
- Data Sources
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Further divided into:

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# Other Resources

**Self Testing:** Test your command of the BoKIR content for each section. Answers are provided with an explanation and with references for further study.

Which of the following is **false**?

- Balance sheets show only assets and liabilities.
- Income statements show data on current operations, including operating income, other income and deductions from income, interest charges, and extraordinary items.
- Cash flow statements show all sources of cash inflow and outflow for the operator.
- All financial statements should be reported separately for the operator's utility operations and non-utility operations.

**Glossary:** Keywords throughout the text are hyperlinked to a glossary for complete definitions (also available in other languages).

**Income Statement:** An accounting statement that relates *sales*, *expenses*, and *net profit* for a given period.

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