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THE CROSSROADS OF UTILITY ROE AND INVESTMENT

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Utilities are at a challenging crossroad of increased capital spending to maintain and future-proof their assets to meet increasingly stringent state demands, while simultaneously maintaining affordability for their customers. As stakeholders, regulators, and utilities search for methods to make additional "room" for competing expenses, utilities need to attract sufficient capital at reasonable rates. With this consideration, it is important to recognize that the cost of equity reflects the utility's cost of raising and retaining equity capital required to serve customers, and therefore should not be viewed as a discretionary lever.

The return on equity ("ROE") is one of the key costs that utilities must recover in their rates to maintain financial viability and attract capital for investment in their rate base and operations. While the ROE is not directly observable or measurable, it is not a discretionary cost for utilities. The U.S. Supreme Court established the guiding principles for establishing a fair return for capital in two seminal cases: *Bluefield Water Works and Improvement Co. v. Public Service Commission*, and the *Federal Power Commission v. Hope Natural Gas Company*. In these cases, the Supreme Court recognized that a regulated public utility cannot remain financially sound unless the return it is allowed to earn on its invested capital is at least equal to the cost of capital; and a regulated public utility will not be able to attract capital if it does not offer investors the opportunity to earn an investment return equal to the return they expect to earn on other investments of similar risk. Reducing authorized ROEs below a just and reasonable level and adopting more leveraged capital structures as a lever to lower bills may have rippling effects on the utilities' ability to attract capital and credit quality. Ultimately, the degradation of utilities' financial viability would bring unintended negative consequences to customers in the form of diminished quality and reliability of utility services.

Increased capital spending for publicly traded energy utilities, expected to expand from $166 billion in 2023 to $191 billion and 183 billion in 2025 and 2026,[1] respectively, has been driven by state mandated energy goals, coupled with rising costs for storm and wildfire preparedness and recovery, will compete for "room" on customer bills. Although stakeholders may view authorized ROE and capital structure as an easy means of reducing rates, such actions could make it more difficult for utilities to access the significant amounts of capital that will be needed to improve reliability, transition to cleaner energy sources, and harden their systems from climate effects. Alternative solutions may include budget and productivity optimization, innovative regulatory mechanisms such as performance-based regulation and performance incentive mechanisms, and asset securitization of storm and severe weather-related costs.

[1] S&P Global, "RRA State Regulatory Evaluations – Energy," August 7, 2024.

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