

American Gas Association

Sound Financing Delivers Lower Utility Bills

How Risk, Return, and Capital Markets Shape Utility Financing and Customer Costs

September 2026

An American Gas Association Report Prepared by

MCR



Copyright © 2026 American Gas Association. All rights reserved.

This report was prepared for the American Gas Association (AGA) by MCR Performance Solutions (MCR) to provide the perspective of an experienced utility financial analyst and investor on the topic of utility return on equity. The author, Sam Brothwell, is Vice President of Strategic and Financial Advisory Services for MCR. Mr. Brothwell holds a CPA certificate, and his experience includes nearly two decades as a financial analyst covering utilities in North America, Latin America, Australia, the United Kingdom, and Europe for Moody's Investors Service, Merrill Lynch, Wells Fargo, and Bloomberg. Mr. Brothwell also spent a decade as a professional utility investor and head of research for Energy Income Partners, a Westport, CT-based energy infrastructure fund manager. He has also headed investor relations for two U.S.-based electric and natural gas utility companies.

Contents

Executive Summary 4

Rising Utility Bills, Political Pressure, and Misperceptions 6

Cutting Allowed ROE to Lower Bills Will Drive Away Needed Capital 9

Risk Assessment and Capital Formation in Competitive Markets 11

Utility Capital Structure: Roles of Debt and Equity 12

Benefits of Strong Equity Financing and Capital Market Access 13

Allowed ROE, Earned ROE, and the Actual Cost of Equity 14

A Utility Investor Perspective 16

ROE Also Drives Credit Ratings and Cost of Debt 17

Conclusions and Policy Implications 18

Executive Summary

U.S. utility bills have been rising in an already inflationary environment over the past five years, catching the attention of consumers, regulators, advocates, and numerous state governors. Rising energy costs are also drawing attention to utility finance.

Simply stated, utility rates are meant to cover all costs incurred in providing service, including fuel, operating, and maintenance expenses. Rates paid by utility customers also include the cost of financing the assets used in the business, which includes interest on debt plus a reasonable return on shareholder equity, also known as return on equity or ROE.

In response to legitimate affordability concerns, some stakeholders have proposed reducing utilities' allowed ROE or increasing the use of debt financing as a way to curb bills. These proposals deserve careful evaluation because financing policy affects customer costs for long periods of time. While simple on the surface, these narratives ignore the critical relationship between perceived risk and the return that investors expect. If adopted, these proposals could undermine access to the capital needed for investment in critical energy systems by driving financing costs higher and taking consumer energy prices with them.

This report explores the relationship between risk and investor expectations, the synergies between debt and equity (stockholder) financing, and the importance of having access to both to ensure safe, reliable, resilient, and affordable energy delivery. Rate regulation is a unique and significant risk consideration for those who invest in the utility sector, and actions that heighten that risk will raise the cost of financing—which is ultimately recovered from customers through rates. Key topics include:

- **Utilities are entering an unprecedented period of capital investment,** driven by rapid growth in energy demand and the need to strengthen system reliability and resilience against extreme weather, wildfires, physical security risks, and rising cybersecurity threats. Policymakers and regulators must carefully balance sustaining reliable utility services against affordability goals and the need to attract and retain investor capital.

- **Financing (i.e., capital) cost is determined by risk vs. expected returns.** U.S. Treasury bonds are widely viewed as having minimal risk, and that's reflected in their low rate of interest—or yield—in the market. At the other end of the spectrum, riskier investments, such as investments in technology start-up companies, offer the *opportunity* of substantial returns if they succeed. Utilities have historically been viewed on the lower risk end of that spectrum.

- **Utilities have access to two primary forms of financing—debt and equity—and they typically depend on both.**

    - **Debt has a stated, contractual cost.** Interest rates are defined, as are terms and timing of repayment, and are directly observable.

- **Equity capital (i.e., stock financing) has no comparable contractual price.** Because companies are not obligated to pay dividends and shares don't come with a repayment promise, equity investors expect a higher return (i.e., a higher cost of capital) than creditors do.

- **Equity supplies substantial funding for utility investment**—including new pipelines, grid modernization, and clean energy projects—beyond what could be raised through debt alone. As such, maintaining the confidence of equity investors is critically important.

- **Both forms of capital finance are essential.** They work together as an integrated foundation to finance investments that maintain safe, reliable, and affordable service. Equity provides a buffer for debt, similar to the implicit government support that sustains municipal utility credit. A strong equity base supports higher credit ratings and lower borrowing cost. Debt capital is cheaper because interest is tax-deductible, but having too much debt and little to no equity weakens credit strength and leaves a company with minimal financial flexibility—like an overextended consumer with maxed-out credit cards and no savings.

  - Few utilities generate enough internal cash flow to fund their ongoing investments, driving an ongoing need to access external capital.

- **Allowed ROE, earned ROE, and cost of capital are related but distinct concepts that are sometimes conflated in public debate.** ROE is often used as a proxy for utility profits. This can lead to claims that allowed ROE creates shareholder windfalls or that reducing allowed ROE would not affect a utility's ability to raise equity capital by selling shares of stock. Such claims overlook the distinction between the return authorized by regulators, the return a utility actually earns, and the return investors require to provide capital.

  - Importantly, allowed ROE does not guarantee a certain profit, but instead sets a level of revenue giving the utility the *opportunity* to earn a fair return.

Definitions

Allowed return on equity (ROE) is determined in a regulatory setting, based on a factual inquiry into the level of risk present in the regulated utility market. Allowed ROE remains fixed until changed in a rate case. Allowed ROE does not guarantee that the company will earn that return or make a profit.

Earned ROE is a company's net income divided by its book value (defined below). Earned ROE is a historical accounting measure determined as financial results are reported (typically quarterly for U.S. companies).

Cost of capital is determined by investor perception of the risk/reward relationship for a given investment opportunity, such as investing in U.S. Treasury bonds or buying a share of stock. Cost of capital may be determined in private or public markets and is subject to constant change.

Book value is the accounting value of a company, calculated as what it owns (assets) minus what it owes (liabilities), representing the net value left for shareholders.

- **Reducing ROE below market expectations increases utilities' financing costs and can undermine long-term affordability.** Lowering ROE reduces utility revenues, lowering cash flow and undermining debt coverage ratios that are key to credit rating determination.

- **Forcing overly debt-heavy capital structures might briefly reduce utility rates by a very modest percentage, but only by sacrificing long-term utility financial health.** Lower allowed returns shrink earnings and cash flow, pressure credit ratings, and can increase the cost of debt. When investors lose confidence, they "vote with their feet" by selling shares or demanding higher returns for higher perceived risk. Either way, utilities end up with higher financing costs which will not lower customer bills.

- **If policy choices make one utility significantly less attractive, investors simply redeploy their capital** to other sectors or jurisdictions, leaving the utility struggling to fund its operations and growth.

Since the mid-20th century, investor-owned utilities have financed the world's most robust energy transport and delivery networks by drawing on both debt and equity capital. Much of that capital comes from investors seeking to protect their invested assets (principal) while also earning interest or dividends. These investors include not only individuals but also insurance companies, pension funds and retirement plans, state and local governments, and not-for-profit foundations and endowments.

As discussed below, rate regulation was conceived as a substitute for competition in the utility industry's formative years to restrain the exercise of monopoly power. However, the regulated monopoly model also plays a critical risk-management role that helps ensure access to the financing needed to maintain the extensive and complex networks that move electricity, natural gas, water, and wastewater—infrastructure that's working harder today than ever. A balanced regulatory approach is needed—one that addresses affordability while preserving a financing framework that sustains utilities' access to capital.

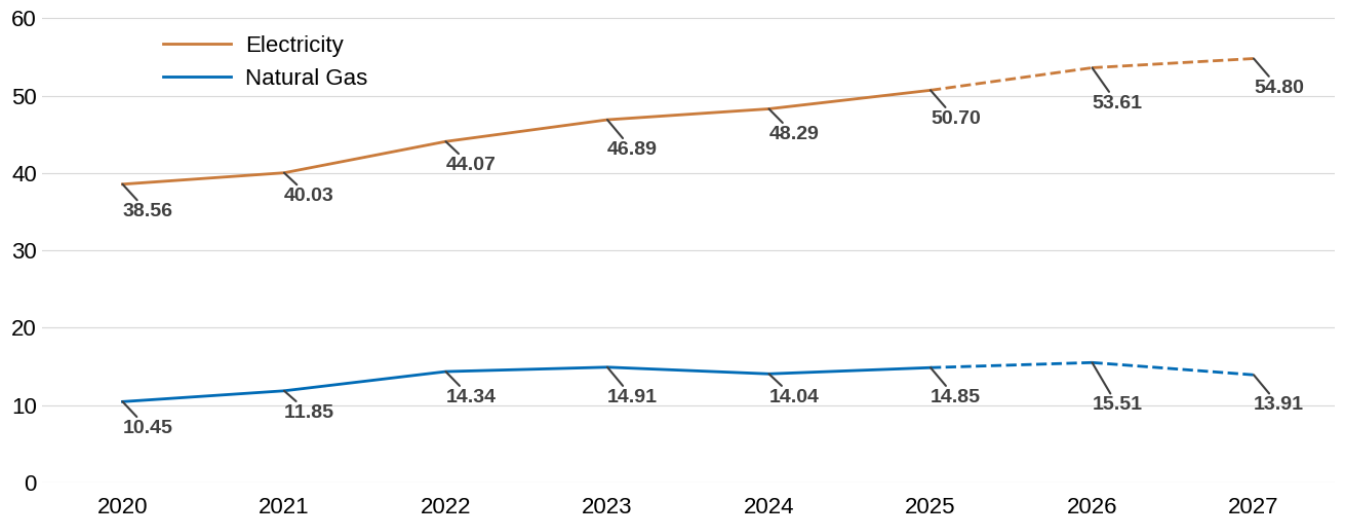
Rising Utility Bills, Political Pressure, and Misperceptions

Energy affordability has become a prominent political issue. After a decade of relatively flat utility bills, households in some regions have seen over 30% growth in residential energy prices since 2020. While natural gas enjoys a meaningful cost advantage relative to electricity, the perception of rapidly rising bills affects sentiment toward all utilities. At the same time, some stakeholders in the regulatory process have begun advocating to freeze utility rates and/or cut allowed returns, following a false narrative that utility monopolies are earning outsized profits while consumers suffer.

The concern is real: Customer bills have risen, largely due to factors beyond utility control. Pandemic-era supply chain disruptions, a surge in inflation, rising labor costs, spikes in fuel and commodity prices, state and federal policy decisions, and higher interest rates have pushed delivered energy costs higher. A 2023 white paper by MCR highlighted this phenomenon. The "triple-2" tailwinds—the once supportive trifecta of $2 natural gas, 2% inflation, and 2% interest rates—have turned into

headwinds, dramatically increasing costs across the economy. While utility bills have tended to follow general inflation rates over time, Figure 1 shows how residential electric and natural gas prices have risen since 2020.

Figure 1: Annual Residential Electric and Natural Gas Prices in Dollars per MMBtu

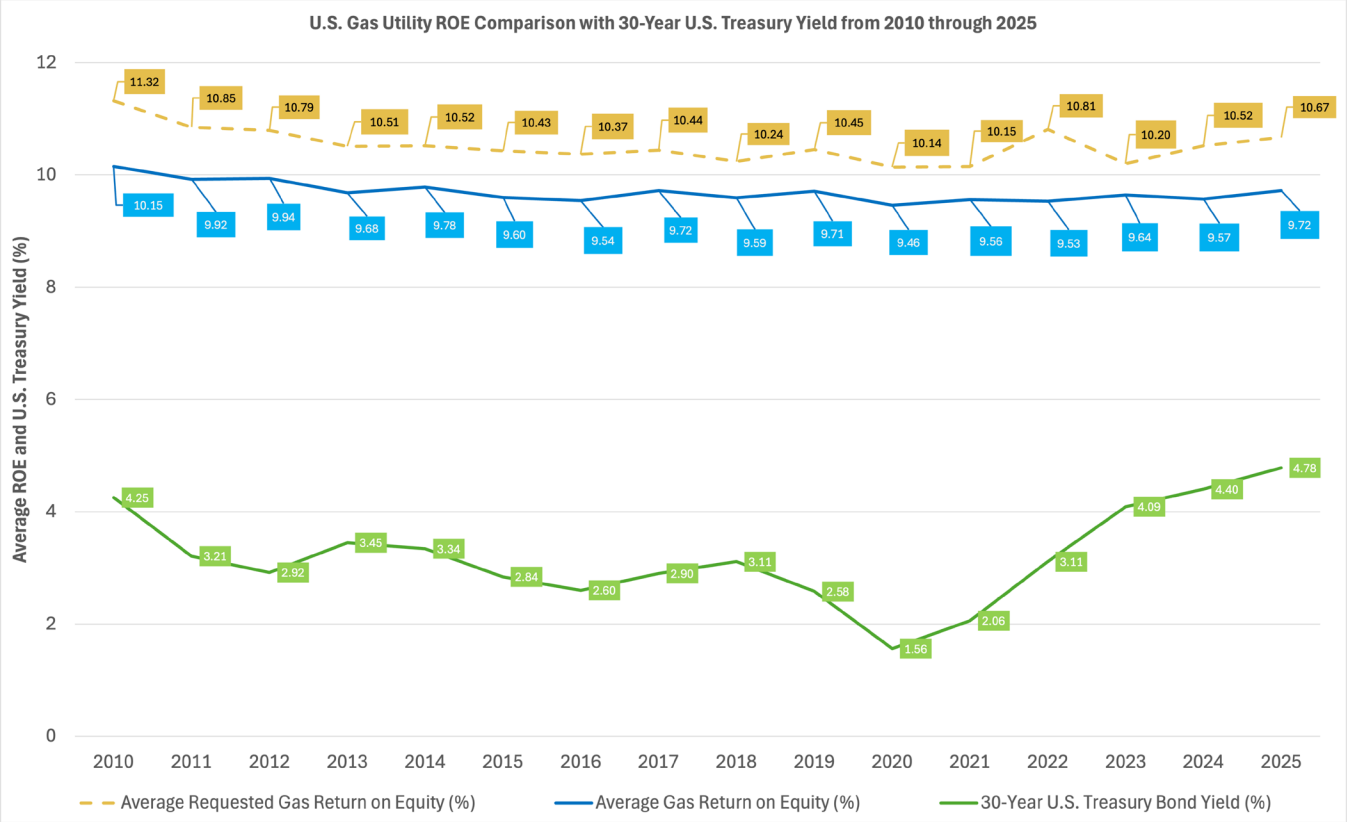


Source: U.S. Energy Information Administration, July 2026 Short-Term Energy Outlook. Chart: American Gas Association. Subject to revision. Dashed lines represent forecasts.

Energy consumers feel the effects, particularly as the cost of other essentials such as food and housing have also risen sharply. Against this backdrop, a narrative gaining attention among consumer advocates and some policymakers holds that the allowed ROE that regulators authorize for utilities' shareholders is unnecessarily high, creating shareholder windfalls. As a result, the topic of utility finance and allowed ROE has emerged as a potential lever to reduce rates.

However, as Figure 2 shows, while other costs that drive utility rates have risen, allowed ROE has trended gradually but steadily *downward* over the past 15 years, even as prevailing interest rates moved sharply higher due to central bank rate hikes aimed at taming post-pandemic consumer inflation.

Figure 2: 15-Year Trend in Utility ROE



Source: S&P Global, Bloomberg

Figure 2 also reflects the relative stability of utility ROE over time, a characteristic that attracts investors seeking to avoid volatility in the value of their invested assets or principal. Stability of principal, coupled with steady income (from dividends and interest), is why utility stocks (equity) and utility bonds (debt) are often owned by individual retirement accounts, public and private pension funds, life insurance companies, and not-for-profit endowments and foundations.

Utility stocks and bonds are often owned by individual retirement accounts, public and private pension funds, life insurance companies, and not-for-profit endowments and foundations.

Investors' return expectations (read: what they expect to be paid for providing financing) reflect their risk/reward objectives. Slashing utility returns or forcing heavily debt-financed structures would undermine stability and heighten investor risk, driving required returns and borrowing costs *higher.* The following sections explain the fundamentals of how utilities attract capital and why sound financing policies are critical to keeping long-run customer costs low.

Cutting Allowed ROE to Lower Bills Will Drive Away Needed Capital

Amid broader discussions concerning affordability and specifically utility ratemaking, some stakeholders have proposed significant changes to the processes used by utility regulators to determine allowed ROE. This messaging centers around some key themes: (1) that the allowed ROE should equal the cost of capital, (2) that utilities trading above book value imply excess profits being earned, and (3) that the cost of equity capital in the market is substantially (i.e., 250 to 300 basis points) below the current average allowed ROE. This argument baselessly claims that utility shareholders have reaped windfall profits and that ample financing would remain available on favorable terms even if ROE is significantly reduced.

In a recent rate proceeding, a state consumer advocate has taken the position that the allowed ROE be set at 6.74% based on what that consumer advocate alleges is the average of market cost-of-equity estimates from three major financial firms and a prominent university. This is roughly 200 basis points less than that same consumer advocate's recommendation just 3 years prior. Further, this recent recommendation is less than 1 percentage point higher than the current yield on mid triple-B-rated utility bonds, which are contractually obligated to pay interest and return principal—key risk-mitigating attributes not found in equity (shares of stock).

Interestingly, the three major financial firms referenced—BlackRock, State Street, and Vanguard, which are prominent managers of union and pension funds—are coincidentally among the largest shareholders in most publicly traded utility companies. As discussed later in this report, investment-grade utility bonds offer a near-6% yield with a stated maturity date and promise of repayment. Thus, it seems unlikely that such

Rate-Setting, ROE, Capital Structure, and Cost of Capital

In the industry's early days, utilities were widely considered natural monopolies, as duplicative miles of wires and pipes would be impractical, unpleasant, and economically wasteful. Utility regulation was introduced to protect consumers from monopoly pricing power while also assuring utility investors' protection from competition, critical in attracting investors to immovable, long-lived assets.

For a typical business, competitive market forces determine demand and price for a given product. Revenue equals units sold times price. Subtracting operating expenses, including the cost of interest expense on loans, determines net income, or profit. Dividing that by the owner's investment in the business ("equity") determines return on invested capital, or ROE.

Lacking market competition, utility regulation starts by determining a reasonable overall investment return on the assets (poles, wires, pipes) used in the business, called the "rate base." Regulators also determine the appropriate mix of debt and equity (shareholder) financing. The cost of debt is simple—it's the interest rate on borrowed capital. The allowed ROE is meant to approximate a return sufficient to attract equity investor (stockholder) capital.

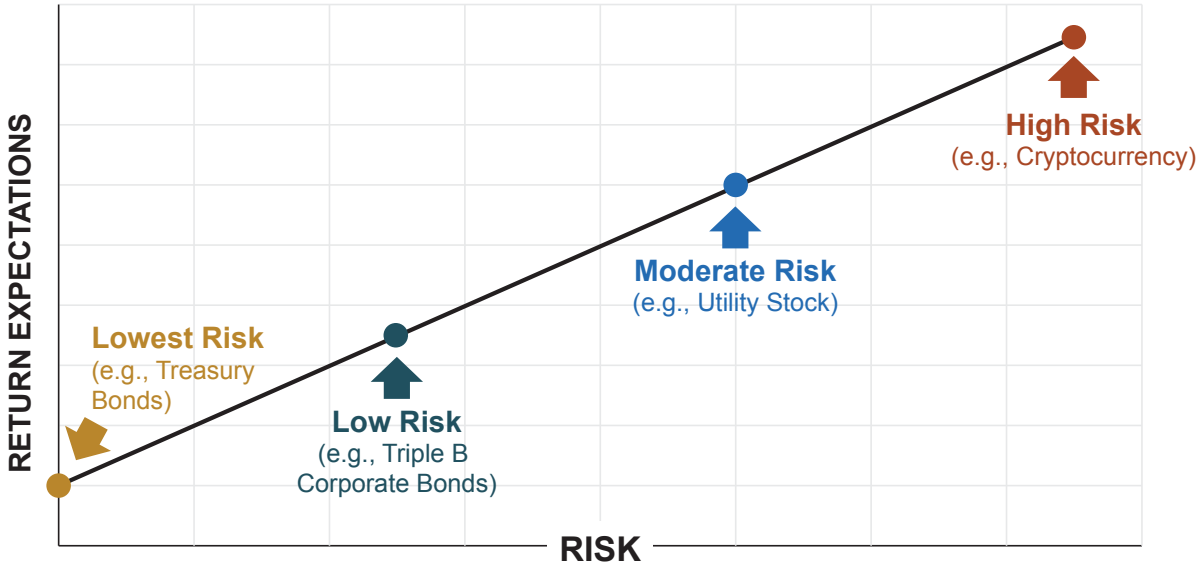
Cost of capital is best defined as the price a company pays to get the money it needs to invest and grow. Investors (stockholders) and lenders expect to be compensated for the risk of providing that money, so the cost of capital is the return they require to invest or lend.

large utility shareholders would accept a sub-7% equity return when bonds are a far less risky alternative with a similar return.

The customer savings that could result from such a recommended reduction in allowed ROE are very modest. Research by the American Gas Association concludes that a typical residential natural gas heating customer would likely realize a savings of $0.96 on an average bill of $108.40, or less than 1%—which would likely be offset by higher borrowing costs as described later in this report.

Investors generally view utility equity (stocks) as presenting a moderate risk/reward profile characterized by the relative principal protection offered by a regulated, franchised monopoly providing essential energy and water, which face steadily growing demand. The fact that utility stocks offer a dividend instead of defined interest and no repayment obligation (i.e., higher risk) is reflected in higher expected returns (reward) relative to bonds, as illustrated in Figure 3.

Figure 3: Risk/Reward Relationship



Utilities in fact face numerous risks, including physical damage to their systems, changes in energy usage/demand, disruptive technologies, legislative and policy shifts, and macroeconomic considerations such as rising interest rates and inflation.

Importantly, a key risk unique to utilities is rate regulation. While competitive businesses face market competition, utility revenue, cost recovery, capital structure, and profitability are all determined by a factual inquiry by elected or appointed regulators at the federal and state (U.S.) or provincial (Canada) level. The rate-setting process often brings about extended periods of uncertainty as a rate case is litigated, which can increase the company's perceived risk among investors.

Finally, the assertion that a public utility's stock trading at a premium over book value signals excess profits ignores the fact that utilities compete with other industries and companies for investor capital.

The stocks in the S&P 500 index currently trade at nearly six times book value, reflecting investor expectations for future business and earnings growth. For comparison, U.S. utilities trade at around two times book value.

Trading at or near book value implies a steady-state, zero-growth environment with little to no need for incremental capital. That is simply not the case for today's utilities, which face nearly unprecedented growth along with an urgent need to strengthen their infrastructure. Adjusting ROE to align share price values with book value flies in the face of the growing demand that today's utilities experience and would undermine the ability to attract capital needed to keep pace with that growth in competitive markets.

Risk Assessment and Capital Formation in Competitive Markets

How is risk—and, by extension, the cost of financing—determined? In evaluating credit, the investor's fundamental question is "Will I get my money back, with interest?" Analysis accordingly focuses on what risks might render a borrower unable to pay its debts. Like household or business borrowing, a utility's perceived risk profile determines the price it pays for financing. Lenders assess business risks that drive the ability to pay—analogous to an individual's credit score—and demand higher returns for higher risk. For example, a homebuyer with a low credit score incurs a higher effective cost of borrowing because the homebuyer must either purchase private mortgage insurance or pay up-front interest ("points") to qualify for a loan.

The major credit rating agencies, including Fitch Ratings, Moody's, and S&P, score the credit of corporations and governments using letter-grade ratings that reflect the likelihood of default. While rating structures vary, debt with a triple-A rating presents the lowest risk, while C ratings warn of current or imminent default. A borrower's ability to issue debt and the cost of that debt (the interest rate charged) vary accordingly.

Equity evaluation shares some common elements with credit analysis, including financial strength and ability to pay. However, the equity investor isn't asking about repayment; the issuer has no obligation to return anything. Getting money back means finding another buyer for the stock—and the investor may or may not get back the price paid for it. These buy-and-sell transactions take place daily on platforms such as the New York Stock Exchange and Nasdaq, or increasingly via online trading. The fundamental question for an equity investor when assessing risk and buying a share of stock is whether the risk of losing the investment is outweighed by the opportunity to earn a reasonable return.

The cost of capital is dynamic and market-driven, unlike the static parameters used in regulatory proceedings. Any action increasing investor-perceived risk to utilities (such as artificially suppressing returns) will directly and rapidly affect the utility's cost of obtaining funds to build and sustain essential infrastructure.

Utility Capital Structure: Roles of Debt and Equity

Investor-owned utilities finance their assets with a mix of debt and equity capital. Both forms of capital are essential, and they work together as an integrated system to finance utility investments that maintain safe, reliable, and affordable service. Equity serves as a buffer that protects creditors: A strong equity base supports higher credit ratings and a lower borrowing cost that benefits customers. Too much debt and little to no equity leaves a company with minimal financial flexibility—similar to an overextended consumer with maxed-out credit cards and no savings. Regulatory capital structure (i.e., the approved debt/equity mix) should therefore maintain a prudent balance between affordable debt financing and a sufficient equity cushion.

Each component of financing plays a distinct role in balancing risk and cost:

- **Debt** (bonds, bank loans) is straightforward: It carries a fixed interest rate and a contractual obligation to repay the principal on schedule. Bondholders have first claim on company assets in the event of liquidation and do not share in losses, and interest expense is tax deductible. Accordingly, debt is relatively low-risk for investors and low-cost to issuers. Utility regulators and stakeholders tend to understand debt well. Bonds and loans must be repaid through utility rates, and the cost of debt financing is simple—it's the stated (or coupon) interest rate. Credit ratings, debt coverage ratios, and concepts such as investment grade are easily grasped and commonly referred to in the rate-setting process. Since the cost of debt financing is directly passed through in rates, its customer impact is clear.

- **Equity** (shareholders' investment) is less structured and defined than debt. Equity investors are neither assured nor guaranteed anything: There isn't a promise to repay or a due date, and unlike interest on a loan or bond, dividend payments are discretionary and subject to cash being available after all expenses and other financial obligations have been met. As owners, equity investors share in both profits and losses.

The "cost" of equity is not defined like a bond's interest rate. Equity cost must be inferred from market conditions, which are reflected in the share price relative to expected earnings. The price-to-earnings (P/E) ratio is a measure of how much investors are willing to pay for each dollar of a company's profits. This valuation metric is widely used by investors to compare the stock of one company against another or to compare companies between sectors (e.g., utilities vs. healthcare). Equity also lacks the investment-grade "bright line" associated with debt securities, adding elements of nuance and subjectivity.

The relative fluidity of equity financing makes it subject to debate in rate-setting, with a "shareholder vs. customer" dynamic that's not seen with debt. While allowed ROE offers an opportunity to earn a profit, there is no guarantee. Equity investors bear the risks of expenses exceeding allowed revenues, denied expense recovery, or the arbitrary setting of ROE at a level insufficient to cover the costs of providing service. In exchange for bearing these risks, equity investors expect the opportunity to earn higher returns than creditors do (Figure 4).

Figure 4: Key Differences: Debt vs. Equity in Utility Finance

Attribute	Debt (Bonds/Loans)	Equity (Stock)
Obligation to repay	Principal must be repaid by maturity.	Perpetual; no repayment date.
Stated cost	Generally a fixed interest rate (e.g., 5%).	Dividends are subject to company discretion and earnings growth. Share price is subject to market.
Investor role	Creditor—no ownership stake, no share in profits or losses.	Owner—shares in profit and growth; can gain or lose principal.
Income to investor	Interest (priority claim; must be paid when due).	Dividends (optional); share in profits or losses.
Risk level for investor	Lower—less risk (priority in claims, fixed payments).	Higher—full risk of loss (last in line for returns).
Investor's upside	None beyond interest and principal repayment (no profit share).	Potential stock price appreciation with unlimited upside (if company grows).
Regulatory focus	Highly quantitative (credit metrics, interest rates, coverage ratios).	More qualitative (regulators debate "fair" ROE; focus on balancing with ratepayer interests).

Benefits of Strong Equity Financing and Capital Market Access

Equity financing is essential because it provides access to the full resources of public capital markets. The U.S. equity market is roughly five times larger than the corporate debt market, a gap that has grown over the last two decades. Equity therefore can supply substantial funding for utility investment—new pipelines, grid modernization, clean energy projects—beyond what could be raised through debt alone. Maintaining the confidence of equity investors is therefore key to tapping deep pools of capital at the required scale that utilities need to provide safe and reliable service, especially as energy systems grow.

Equity can supply substantial funding for utility investment—new pipelines, grid modernization, clean energy projects—beyond what could be raised through debt alone.

Policies that attract equity investment in utilities harness private capital for public infrastructure needs. Conversely, if a jurisdiction pushes equity away, it must either rely on costlier forms of capital (i.e., higher interest rate debt resulting from less equity) or accept reduced investment. Either outcome can push up the cost of service over time. Therefore, maintaining a reasonable allowed ROE and balanced capital structure encourages continued public equity participation, spreading risk and cost efficiently among many investors.

Utilities remain in a cycle of high capital investment, driven by the need to improve system resilience and reliability by protecting infrastructure from physical threats such as extreme weather and wildfire risk as well as rising cybersecurity threats. At the same time, energy demand further drives the need for greater electric and gas infrastructure investment. As a result, few, if any, utilities generate enough internal cash flow to fund their capital requirements, driving an ongoing need for external capital. Since financing costs are included in customer rates, deliberately increasing those costs would be counterproductive.

Allowed ROE, Earned ROE, and the Actual Cost of Equity

Utility regulators set an allowed ROE and capital structure (percentage share of debt and equity) through periodic rate cases, typically using theoretical models, professional staff, and business judgment. Allowed ROE does not guarantee a certain profit, but instead sets a level of revenue giving the utility the *opportunity* to earn a fair return on its equity-supported assets. If the utility can operate efficiently and control costs, it may earn up to that percentage. While financial analysts' earnings estimates and growth rates are utilized in the modeling process, actual investors or other capital market participants are rarely, if ever, involved in determining regulatory ROE.

The ROE allowed in rates is meant to set a fair rate of return for shareholders, one *commensurate with the risk* of investing in the utility and sufficient to attract capital. The principles and standards behind this concept were set forth in *Hope Natural Gas*[1] and *Bluefield Water Works,*[2] two landmark Supreme Court cases that challenged state regulatory decisions in the early to mid-20th century.

Timing, often referred to as regulatory lag, is also a major consideration. While allowed ROE is determined at a point in time according to the regulatory process, a utility's capital *needs* and timing are dynamic and driven by factors ranging from customer growth to weather. Similarly, the cost of capital changes daily according to a host of macroeconomic factors including central bank policy and employment trends. Most U.S. utilities fail to earn the allowed return due to a mismatch of expenditure timing and regulatory allowance, weather conditions that depart from projections, increases in the market cost of capital, or general inflation outpacing allowed revenue.

Most U.S. utilities fail to earn the allowed return due to a mismatch of expenditure timing and regulatory allowance, weather conditions that depart from projections, increases in the market cost of capital, or general inflation outpacing allowed revenue.

Expected return is commonly *estimated* by tools including the capital asset pricing model or discounted cash flow models, which seek to replicate investor return expectations based on forward earnings estimates, and measures of risk and volatility relative to the broader market. Allowed ROE is often compared with the ROE of a peer group of comparable companies. Regardless of how it is derived, however, allowed ROE is a static snapshot estimate of market return requirements. It is not equivalent to the cost of equity capital, which is set daily by buy-and-sell decisions executed on public equity markets.

[1] *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. 591 (1944).
[2] *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia,* 262 U.S. 679 (1923).

Importantly, these decisions are made on a relative basis. Industries, sectors, and individual companies all compete for investor capital. A century ago, utilities were the market's high-flying technology stocks, but that's no longer the case as utilities now represent less than 3% of the S&P 500's total value. In contrast, the "Magnificent Seven" technology stocks comprise a substantial percentage of value in the market, *a reflection of investor expectations of phenomenal business and earnings growth over a long period.* Every other company and sector must compete with those seven dominant stocks for market capital.

A century ago, utilities were the market's high-flying technology stocks, but that's no longer the case as utilities now represent less than 3% of the S&P 500's total value.

Individual utility companies must remain attractive on a risk-adjusted basis, relative to other sectors and to other utilities competing for equity capital. Twenty years ago, Google chose to conduct its initial public offering by the unconventional means of a reverse, or "Dutch," auction open to large and small investors. This was a novel approach, and was very successful *because everyone wanted to get shares of Google's stock.* It has been suggested that utilities could follow a similar approach, but the slower-growing utility sector generally offers less potential for earnings growth and capital appreciation than higher-growth industries like the technology sector.

On valuation, most tech stocks currently trade at close to a 30X price-to-earnings (P/E) ratio, a low cost of capital reflected in strong market demand for their stocks. The average utility's P/E ratio, by contrast, is closer to 16X, and utilities facing considerable regulatory uncertainty trade at a discount to that average.

Apart from being less highly valued in the market, utility stocks face a related hurdle in attracting capital: their market share. Most stocks today are owned by exchange-traded, index-driven funds that are mostly algorithmically driven and allocate their assets on the basis of market valuation. Accordingly, stocks of the large technology companies dominate these funds' assets, while utilities make up a minuscule portion.

Allowed ROE and capital structure do not dictate the cost of financing in competitive capital markets, *but they are important and highly influential risk signals.* State executive branch intervention in utility rate-setting—particularly calls for lower ROE and greater reliance on debt—can increase uncertainty among utility investors, causing share prices to weaken. Such actions may also lead to credit rating downgrade reviews and higher borrowing costs.

A Utility Investor Perspective

Institutional investors such as fund managers also compete for client dollars on the basis of overall performance relative to the market and alternative investment products. A professional investor must always compare alternatives and consider the risk-informed opportunity cost of investments not made, whether in the form of debt versus equity, geography, a sector or industry, or specific companies.

Buy-and-sell decisions are driven by factors ranging from the macroeconomic (e.g., interest rates or commodity prices) to sector allocation (e.g., a decision to increase or decrease exposure to utilities generally or to specific electric or natural gas utilities. Investors increase or decrease their specific holdings according to how well a given company's stock aligns with risk tolerance and return expectations. Those decisions can be driven by events, which for a utility could include an unexpected rate case outcome, changes in regulatory tenor, or legislative/policy issues affecting the company's business climate.

If a utility's risk-adjusted returns fall behind other options, investors can and will reallocate their capital elsewhere—essentially voting with their feet. For example, at an allowed ROE of 6.5% (as some critics propose), an investor could earn nearly the same return from a safe utility bond yielding about 6%, but with much lower risk and a contractual guarantee of principal repayment. Figure 5 contrasts a real-world utility bond issued in 2026 to a generic utility stock with a 6.5% allowed ROE. When utility bonds yield around 6%, an allowed ROE of 6.5% may not provide a sufficient earning opportunity to support the higher return equity investors require for bearing greater risk. Put another way, investors will not supply equity capital for returns barely above bond yields when stock risk is so much higher.

Figure 5: Stock or Bond?

Utility Debt

- $800MM bond
- Issued 3/2/2026
- Maturity 12/3/2056
- Rated BBB+ / Baa1
- Coupon 5.75%
- Current YTM ~6%

Stock of Utility "X"

- 6.5% allowed ROE
- Can buy it cheap, but…
- Unlikely to pay a dividend, so no cash yield
- Risk loss of principal
- Growth limited by low return

The risk-adjusted return on a 6% bond is superior to that of the 6.5% ROE stock.

ROE Also Drives Credit Ratings and Cost of Debt

Arguments in favor of lower utility ROE often suggest that only shareholders will be affected, implying that utility credit ratings and cost of debt would be unaffected. That is simply not true. Lowering ROE reduces utility revenues, lowering cash flow and undermining debt coverage ratios that are a key component in determining credit ratings. Figure 6 provides an example of what happens to a generic utility's key financial metrics when ROE is cut from 9.5% to 6.5%.

In this example, the 32% reduction in ROE drives a corresponding reduction in net income. However, taking into account non-cash charges such as depreciation and deferred income taxes, lowering the ROE also results in a 20% reduction in cash flow. Remember, utility regulation solves for net income, which determines the revenue requirement. For any business, regulated or not, a reduction in revenue means a reduction in cash flow.

Figure 6: How Lower ROE Affects Cash Flow and Credit Metrics

		Base	Pro Forma	Δ
		($000)	($000)	
Rate Base		5,000,000	5,000,000	
Allowed ROE	X	9.50%	6.50%	
Equity %	X	50%	50%	
Net Income	=	237,500	162,500	-32%
Income Tax Rate	/1-	30%	30%	
Pre-tax Income	=	$ 339,286	$ 232,143	
Cash Income Tax (15%)		$ (50,893)	$ (34,821)	
DD&A (30 year)	+	166,667	166,667	
Cash from Operations	=	455,060	363,989	-20%
Debt	/	2,500,000	2,500,000	
Cash from Operations/Debt		18.2%	14.6%	

How would that reduction affect borrowing cost? Discussions with utility bondholders suggest that a typical utility operating company with a single-A rating and a cash-flow-to-debt ratio of 19% currently has a medium-term borrowing cost of 70 basis points (0.7%) above the Treasury yield. Two utility operating companies with 14%–15% debt coverage currently see borrowing costs closer to 100 basis points above the Treasury yield.

A 20% reduction in cash flow coverage of either outstanding debt or interest expense would almost certainly trigger a credit rating agency review for downgrade. Credit ratings, however, are not solely driven by numbers. The credit rating agencies emphasize qualitative issues such as the consistency, transparency, and overall credit supportiveness of the regulatory climate in which a utility company operates. Objective, fact-based regulation is preferable to a process that is motivated by short-term politics. These factors equal or outweigh the debt coverage ratios in credit analysis, and a politically

driven one-third reduction in allowed ROE sends a negative signal to lenders about the tenor of the regulatory and policy environment.

In the well-functioning U.S. market, capital will flow to where risk and expected return are appropriately balanced. If policy choices make one utility significantly less attractive, investors simply redeploy their capital to other sectors or jurisdictions, leaving the utility struggling to fund its operations and growth. Those decisions are not made in legislative chambers or commission hearings—they happen daily in the market.

Conclusions and Policy Implications

Energy affordability challenges are real, and policymakers are right to seek solutions for consumers. Utilities make long-term investments in upgrading and expanding energy systems while balancing objectives on safety, reliability, and affordability. Simplistic strategies—like slashing allowed ROEs or mandating debt-heavy financing—are likely to backfire in the long run by raising the cost of capital as previously discussed. These approaches ignore the essential dynamics of capital markets: Risk and return must remain balanced to secure investment. If utility investors demand significantly higher returns due to increased risk, artificially capping returns will not eliminate that expectation—it will simply cause capital to flow elsewhere, eventually forcing utilities and their customers to pay more to attract it back.

Regulation was created to protect customers from the exercise of monopoly power by acting as a surrogate for competition. That mission includes ensuring rates are fair and that utilities can finance the infrastructure necessary for safe, reliable service. Thus, a balanced regulatory approach is needed—one that addresses affordability through targeted measures (e.g., energy efficiency programs, low-income support, cost management incentives) while preserving a financing framework that sustains utilities' access to capital. That means keeping allowed ROEs in line with market realities, not setting them unrealistically low, and maintaining prudent equity levels in capital structures.

A balanced regulatory approach is needed—one that addresses affordability while preserving a financing framework that sustains utilities' access to capital.

In sum, capital formation and pricing are determined every day in global markets, not by regulatory fiat. If the utility sector is to attract the enormous investment needed for modern infrastructure, policymakers must base decisions on an accurate understanding of how utilities are financed. Clear communication is essential: Stakeholders need to understand why an appropriate allowed ROE and healthy capital structure are not giveaways to Wall Street, but rather safeguards for customers in the long run. By ensuring fair, predictable, and stable financial parameters, regulators can meet their dual mandate—keeping energy affordable today while securing the investments that guarantee reliable, affordable energy tomorrow.