

Return on Equity Reform

COST CONTROL



AT A GLANCE



TARGET COST DRIVERS

The policy can help to ease customer cost pressures created by these drivers

- Aging grid structure
- Fuel price volatility
- Misaligned utility incentives



IMPACT TIME HORIZON

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How long it typically takes before changes materialize in utility behavior or customer bills



Medium-term (2-5 years)



POTENTIAL COST SAVINGS

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The level of cost savings that can reasonably be expected to result from this policy



Variable

CONTEXT AND BACKGROUND

About [63% of electricity customers](#) in the United States are served by investor-owned utilities whose rates are regulated by public utility commissions (PUCs), and the regulator-established return on equity (ROE) has a direct impact on a utility’s rate of return (ROR), or profit. In simple terms, ROE is the allowed rate of profit on capital investments made by utilities and accounts for about [15-20% of customer bills](#). The equation below shows the role of ROE in determining a utility’s rate of return.

The terms in blue can be directly calculated and are not a challenge for regulators, while the term in red can only be estimated. The [objective of regulators](#) is to set the ROE equal to a utility’s [cost of equity \(COE\)](#), the rate of return on utility stocks required by investors, but the COE can only be estimated using financial models.

However, the [evidence](#) suggests that authorized ROEs have been consistently higher than COE over the last 30 years. This leads to unnecessary costs for customers and perpetuates “[capex bias](#)”, the incentive for a utility to prioritize capital investments above other solutions (even if they are more cost-effective).

$$ROR = \frac{\text{Cost of Debt} \times \frac{\text{Total Debt}}{\text{Total Capital}} + \text{Cost of Equity} \times \frac{\text{Total Equity}}{\text{Total Capital}}}{\text{Cost of Capital (COC)}}$$

Excess ROEs have cost customers an estimated [\\$5.9 billion per year](#) over the past 30 years. State legislatures can drive ROE reform in several ways such as setting requirements for the financial models used to estimate

COE, providing more support for regulators to understand financial methodology, establishing statutory limits or guidelines for ROE, or linking ROE to state policy objectives using performance incentive mechanisms (PIMs).



REAL-WORLD EXAMPLES

While it's unclear how many states have considered or enacted ROE reforms, at least [six states](#) introduced ROE reform-related legislation in 2025.



Florida considered [legislation](#) (Committee Substitute/Senate Bill 354) which would require the Public Service Commission to keep allowed ROEs close to the risk-free rate of return and submit annual reports to the governor and legislature on ROEs.



Kansas considered [legislation](#) (House Bill 2032) to directly link allowed ROEs to rate increases, allowing regulators to increase/decrease a utility's ROE by 0.5% depending on whether rates increase by less than 1% each year.



New York considered [legislation](#) (Senate Bill S1896), which would have established a common financing methodology by which regulators established the allowed ROE for all regulated utilities.

Other states like [New York, Illinois, and Hawaii](#) have PIMs that can increase/decrease a utility's ROE depending on their performance.



FURTHER READING

- [“Rebalancing ‘Return on Equity’ to Accelerate an Affordable Clean Energy Future”](#), RMI, 2025
- [“Cost of Capital and Capital Markets Primer for Utility Regulators”](#), NARUC, 2019
- [“Demystifying Utility Rate of Return”](#), Mark Ellis, 2023
- [“ROE Model Analysis in the Current Financial Environment”](#), Rothschild Financial Consulting, 2023



IMPACT TIME HORIZON

Medium-term (2–5 years)

ROE is set in rate cases which take [12–18 months](#) to complete. After that, customers will experience immediate bill savings from the reduction in ROE, but the longer-term cost savings coming from reduced capex bias will take longer to materialize.



POTENTIAL COST SAVINGS

Variable

Cost savings will vary with policy design and implementation, and utility ROEs vary from state to state. [Researchers](#) estimate that higher than necessary ROEs have led to excess costs of \$2.5–\$8.8B per year in the United States over the last 30 years, while [other estimates](#) are lower.



LEGISLATIVE DESIGN AND IMPLEMENTATION CONSIDERATIONS

Legislatures can consider several options to reform the process for establishing utility ROEs:

Financial model requirements

Requiring the use of the capital asset pricing model or discounted cash flow model to determine ROE is in line with existing best practice. [Two other common models](#), the expected earnings analysis model and the risk premium model, have been prohibited by FERC for not adhering to sound financial logic; however, utilities frequently employ these models in state proceedings to receive high ROEs. Legislation could also direct regulators to more heavily scrutinize [key model assumptions](#) like interest rates and growth rates which can lead to inflated ROEs. Lastly, legislation which prohibits benchmarking ROEs to utility peer groups can help break the cycle of awarding excessively high ROEs.

Rate of return (ROR) = Cost of capital (COC)

Codifying the ROR = COC standard adopted by the [Supreme Court in 1944](#) would ensure that utilities earn a fair rate of return without imposing excess costs on customers. [Evidence](#) shows

that utility ROEs have been consistently higher than actual utility COEs over the past 30 years, indicating that the allowed ROR for utilities has been much higher than utilities' true COC.

Regulatory framework

Enabling the use of performance-based regulation (PBR) tools like revenue decoupling, earnings sharing mechanisms, and PIMs can better align utility ROEs with state policy goals and mitigate the impact of excessively high ROEs on customers. However, the interplay between these tools is complex so legislatures can consider if regulators need additional support to study and implement these reforms.

PUC support

Providing greater financial training for regulators can help them interpret utility ROE proposals and critique model assumptions and limitations appropriately. [Research](#) has shown that regulators with more financial training have set ROEs more aligned with standard financial principles than

The table below provides examples of how authority and responsibility for ROE reform may be distributed across key entities.

VENUE	POTENTIAL ROLES
Legislature	<ul style="list-style-type: none"> Establish financial model requirements for awarding utility ROEs and/or establish ROE caps or targets Provide additional resources (training, staff, etc.) for regulators to assess ROE proposals Enhance support for customer intervention in rate cases Authorize regulators to use PBR tools to link ROEs to utility performance
Regulator	<ul style="list-style-type: none"> Scrutinize and reduce ROEs if they are high above COEs or based on faulty modeling assumptions Design and implement PBR tools (ex. PIMs) to link ROE to utility performance
Administration	<ul style="list-style-type: none"> Encourage legislatures and/or direct regulators to study the impact of excess ROEs on customer affordability
RTO/ISO	<ul style="list-style-type: none"> No direct role. FERC has established ROE methodologies for transmission

their counterparts, so providing more training to commissioners and staff

could lead to ROEs which are closer to utilities' true COE.