MarketClear
UTILITY POLICY RESEARCH

June 26, 2026

Response to the Letter of Commissioners Yanora and Coleman Opposing House Bill 2224

> *[T]he only witnesses who favored the status quo "were those who benefited from it, the industry and its regulatory agency."*
>
> *Robert E. Litan, on the 1975 Civil Aeronautics Board hearings, quoted by David R. Henderson, Hoover Institution (Dec. 19, 2018)*

> *S]ociety's choices are always between or among imperfect systems, but … wherever it seems likely to be effective, even very imperfect competition is preferable to regulation.*
>
> *Alfred E. Kahn, former Chairman of the New York Public Service Commission*

Dear Senator Ward:

We write in response to the June 10 letter from Commissioners Yanora and Coleman opposing House Bill 2224. We do not doubt the Commissioners' good faith, and we share their stated concern for affordability. But their letter illustrates a familiar pattern: a defense of the existing rate-setting regime mounted by the institution that administers it, in substance echoing the utilities that profit from it. That alignment — the regulator and the regulated on the same side — is worth bearing in mind as you and your colleagues evaluate the arguments they make.

The framework's legality and age are not the questions before you.

The Commissioners describe the current process as "legal" and "century-old." Both are true, and neither is responsive. No one contends the Commission's authority is unlawful; HB 2224 does not question the Commission's power to set returns — it changes the method by which returns are set. The constitutional standard, as we explain below, is satisfied by outcomes, not by the pedigree of a methodology.

Nor is age a virtue here. The cost-of-service model and its battle-of-experts approach to the cost of equity were built when the capital-market infrastructure and data needed to price equity directly did not exist. *Bluefield* was decided in 1923 and *Hope* in 1944. The deep, liquid, continuously quoted markets that now let issuers discover the price of capital every day were not available to a 1923 regulator, who was therefore left to estimate the cost of equity from models. We are no longer so constrained. That a procedure is old is a reason to ask whether newer tools do the job better — not a reason to keep it.

Why the returns the current process produces are too high — on the Commissioners' own chosen methodologies.

The Commissioners rest their numbers on the Capital Asset Pricing Model and the Discounted Cash Flow analysis. We begin with the former, because that is where the overcharge is most readily apparent.

CAPM builds the cost of equity from three inputs: the risk-free rate, an asset's beta (sensitivity to broad market movements), and the equity risk premium (the extra return investors demand for holding equities rather than risk-free assets); the required return is the risk-free rate plus beta times that premium. Take the inputs in turn:

Risk-free rate. The 10-year Treasury, today about 4.4%.

Beta. For utility holding companies this averages roughly 0.4. Adjusted for holding-company leverage and other elements that do not burden the regulated operating company, the operating-company beta is 0.3 or lower.

Equity risk premium. The Federal Reserve's estimate is 2.8%. The major investment banks' five-to-ten-year forecasts agree: they cluster between 6.0% and 7.0% for the stock market; subtracting today's 4.4% Treasury yield from the high end of the range leaves an implied premium of about 2.6%.

Putting these together — 4.4% plus 0.3 times 2.8% — yields a cost of equity of roughly 5.2%, or 0.8 percentage points above the 10-year Treasury.

We note how far the Commission has had to travel from this arithmetic to reach the returns it authorizes. At a time when no major investment bank projects five-to-ten-year market returns of even 9.0% — that is, when even the most optimistic forecast implies an equity risk premium below 4.6% — the Commission's own CAPM analysis adopts a vendor's outlier equity risk premium of 5.0%. With that input, its most recent report derives a CAPM estimate of 10.42% for electric utilities — a figure higher than the expected return on the broad equity market itself (Pa. Pub. Util. Comm'n, Bureau of Technical Utility Services, Report on the Quarterly Earnings of Jurisdictional Utilities for the Year Ended June 30, 2025). And even the outlier premium does not produce that number on its own. Back out the beta the result requires — subtract the 4.4% risk-free rate from 10.42% and divide by the 5.0% premium — and the implied beta exceeds 1.0, on the order of 1.2. No recognized source assigns utilities a beta that high, and none could: a beta of 1.0 is the market average by construction, the capitalization-weighted mean of every sector's beta, and the utility sector is by all accounts the lowest-beta, most defensive sector in the market. The Commission's own model thus implies that the safest sector in the economy swings more than the market as a whole — a result that is less a cost-of-equity estimate than a figure reverse-engineered from the answer.

The Discounted Cash Flow model the Commissioners also invoke tells the same story. Setting out its proper application would require more arithmetic than belongs in a letter to non-specialists, but applied correctly it too places the cost of equity somewhat below 6.0 percent. The model becomes easy to digest only if one accepts a remarkable assumption the Commission builds into it: that the 6.7 percent growth rate it uses — a five-year forecast — will continue not for five years, but in perpetuity. That assumption cannot hold. No enterprise can compound at 6.7 percent forever; long-run nominal economic growth runs closer to 4.0 percent, and any enterprise that grows at a higher rate in perpetuity would in time be larger than the whole economy. Correct that one assumption to any plausible long-term rate and the DCF falls back into line with CAPM, far below the returns the Commission authorizes.

The market itself tells us that utilities are earning too much.

Confirmation that the returns the PaPUC awards are far too high comes from the market's own valuation of Pennsylvania's utilities. The Commonwealth's largest electric utilities sit inside publicly traded holding companies — PECO within Exelon, the FirstEnergy Pennsylvania companies within FirstEnergy, and PPL Electric within PPL. None is a pure Pennsylvania play, but the signal is consistent: Exelon trades at roughly 1.6 times its book value, PPL at about 1.9 times, and FirstEnergy at about 2.2 times. Were the Commission setting allowed returns at the cost of capital and no higher, these shares would trade near book value — 1.0 times — because book value is simply the capital investors have committed, and capital earning exactly its required return commands no premium. Today's substantial price premiums reflect the market's verdict that authorized returns exceed the cost of capital.

The Commissioners offer one further figure: the national median of 9.7 percent. That corroborates nothing. These are authorized returns — the output of the very proceedings at issue — not independent measures of the cost of capital, and the national median is simply their average across the other states, each produced by the same cost-of-service process and the same battle of experts. To cite it is to test the disputed number against a national average of equally disputed numbers. And because each commission in turn looks to comparable returns elsewhere, the practice works as a ratchet: every state's authorized return helps anchor every other's, and the structure as a whole floats free of any independent estimate of what equity actually costs. The CAPM, DCF, and market evidence set out above are tethered to that cost. The national median is tethered only to itself.

The default return is a rebuttable presumption, neither a requirement nor a placeholder.

The Commissioners call the default a "placeholder" with "no independent analytical basis." As detailed above, the default rate was specifically designed to exceed the cost of equity under a properly specified CAPM. Pennsylvania's utilities face none of the large, uninsurable catastrophe exposure that elevates the cost of equity in some other states, and they present the ordinary, low-beta risk profile of regulated distribution — so for Pennsylvania the margin is especially generous. That margin is deliberate: a default set above the cost of equity, not at it, leaves no utility a credible claim that its return is confiscatory under *Hope* and *Bluefield*.

Moreover, the Commissioners are incorrect about the number's role in the statute. The bill does not impose the spread as a fixed finding of the cost of equity; it establishes the default as a rebuttable presumption and places the burden squarely on the utility to show, through the auction, that its cost of equity is higher (Section 1381(d)). The default is a safe-harbor starting point, not a final determination — which is precisely why its exact calibration matters far less than the Commissioners suggest. Any utility that disputes it may decline it and let the market set its return.

Far from stingy, a default near 6.4% approaches the expected return on the whole stock market — for a security materially safer than the market.

The auction does not fail to discover price — discovering price is the only thing it does.

The Commissioners argue the competitive equity auction cannot produce "meaningful price discovery." That has it exactly backwards. Price discovery is not something an auction might fail at — it is what an auction is for, and a uniform-price sealed-bid auction is its canonical form: the instrument the U.S. Treasury uses to sell its securities, that PJM uses to procure capacity, and that sets the price of capital across the debt markets every day. Its clearing rate is, by construction, the lowest return at which the offered equity is fully subscribed — the least the market will accept to supply the capital.

It is worth being precise about what the auction would replace. *The current process does not measure the cost of equity; it estimates it — an administrative judgment about what investors would demand, reached without asking any of them.* That is the difference between an appraisal and a sale. No one supposes a Zillow estimate is a better measure of a house's worth than the price a buyer actually pays for it; the sale reveals the value, the model only predicts it. The Commission's figure is anything but independent: it emerges from a contested proceeding in which the regulated utilities are its most active participants. The auction puts to the market the question the current process can only guess at.

The Commissioners are right that auctioning a small tranche, rather than a large block, is typically associated with a modest return premium: a thin offering may clear at a slightly higher return than a deep, liquid one. But the municipal market, where issues are routinely sold in tranches smaller still, shows how modest that premium is — tiny relative to the gap between a market-clearing return and the returns the current process awards. The small tranche is, moreover, a deliberate choice. We would gladly see far more of a utility's equity priced this way — indeed all of it — but the bill samples only the smallest quantity needed to read the market's required return, much as a biopsy takes only the tissue needed for a reliable diagnosis. This minimally intrusive approach was designed precisely to foreclose the objections a utility might otherwise raise to a larger compelled issuance.

The remaining objections to the auction are answered just as readily.

- That a utility's affiliates may bid does not eliminate arm's-length pricing: in a uniform-price auction the clearing return is set by the whole order book, filled from the lowest bids upward, so an affiliate cannot push the auction-set return above what independent investors willing to supply the capital will accept. Indeed, while this provision was included so that utilities could not complain of being excluded, we do not expect utilities and their affiliates to participate, as their doing so can only lower the resultant auction rate.

- The five-bidder threshold the Commissioners fault is the very safeguard that secures that competition. And the premise that a small utility cannot meet it is empirically mistaken: the most comparable market — taxable municipal debt — prices issues of exactly this scale every day, and the Municipal Securities Rulemaking Board reports that 45 percent of all new taxable municipal issues are $5 million or less, securities that routinely attract competitive bids. A small utility's equity is no harder to price than the grab-bag of local projects that underlie these issues.

- A utility that nonetheless cannot field a competitive auction, like one that simply prefers not to, is not stranded — it takes the default, a market-referenced return delivered without the cost or delay of a contested case. The same answer meets the concern for smaller and rural utilities, including those facing PFAS and lead-service-line mandates: the auction is an option, not an obligation, and forgoing it costs them nothing, while every dollar of that prudent investment stays in rate base earning the authorized return. And that the default binds a utility which forgoes the auction is no asymmetry but a sound inference — a utility free to prove a higher cost of equity, and choosing not to, has conceded by that silence that an auction would be expected to yield no more than, and likely less than, the default it declines.

A market test the industry resists is a market test the industry expects to lose.

There is a tell in the opposition. If the bill would truly force returns below the level needed to attract capital, the utilities would be the first to embrace the auction — it would be their cleanest, most credible way to demonstrate a higher cost of equity and have it written directly into rates. Instead, the industry resists. The only coherent reason to fear a market test is the expectation of failing it — that the auction would clear below the returns the current process awards.

The bill does not raise a "substantial constitutional question" — it answers the constitutional one more directly than the status quo.

The Commissioners invoke *Hope* and *Bluefield*. Those cases require that an authorized return be commensurate with returns on comparable-risk investments and sufficient to maintain credit and attract capital — and no more. Critically, *Hope* establishes an "end-result" test: it is the result reached, not the method employed, that controls. No methodology is constitutionally privileged, and commissions operate within a broad "zone of reasonableness" (*Permian Basin*, 1968), inside which a rate cannot properly be attacked as confiscatory. A utility challenging a rate bears a heavy burden to show convincingly that the end result is confiscatory.

Against that doctrine, an auction-derived return is not a constitutional vulnerability — it is the most direct possible satisfaction of the capital-attraction standard. *Bluefield* asks what return is necessary to attract capital on comparable terms; the auction puts that question to the capital markets themselves and records their answer. *Hope* frames the question more broadly, as a balancing of investor and consumer interests. The auction strikes that balance by design: investors will not bid below a fair return, so the rate it sets cannot be confiscatory, while competition among them holds it no higher, so ratepayers are not overcharged. A framework that protects both interests at once does not flirt with confiscation. It forecloses it.

The Commissioners' final concern is an important one: litigation is likely, and the prospect of ratepayers paying for it deserves to be taken seriously. But this does not weigh against the bill — if anything, it underscores why the reform is needed, for the concern is a symptom of the very capture the bill exists to cure. Pennsylvania's commission already holds the authority to deny a utility recovery of any cost it finds imprudent or unreasonable.

That risk, moreover, is one the legislature can foreclose. It may be wise to amend the bill to state plainly that legal expenses a utility incurs in an unsuccessful challenge are not recoverable. The legislature may wish to go further, and provide that once a utility's claims have been fully and finally defeated, the utility must bear the Commonwealth's legal costs as well, with interest.

The bill is in any case built to withstand challenge: by putting the capital-attraction question to the market, the auction satisfies *Hope* and *Bluefield* directly and positions the bill to win the constitutional question rather than litigate it without end. A bill that also ensures the losing utility, not the public, pays for a meritless fight removes the very risk the Commissioners invoke.

The remaining objections.

Implementation. The objection conflates two different tasks. Setting the default requires neither rulemaking nor adjudication: it is a formula — the 10-year Treasury plus two points — applied to the existing rate base, which is why an order within 60 days and a rate adjustment within 120 are workable. And because the bill provides a true-up with interest for any gap before adjusted rates take effect (Section 1381(j)), no party is prejudiced if implementation runs long. The auction is a separate matter on a separate clock — triggered only when a utility petitions or the Commission moves, with its own rulemaking (Section 1382(g)). Nothing requires the Commission to stand up a full auction apparatus for every utility in 120 days, or at all for a utility that never petitions.

Credit and the Moody's opinion. The premise that a lower allowed ROE must weaken credit does not hold. A lower ROE, standing alone, reduces a utility's income and would pressure the cash-flow ratios the rating agencies watch. But the Commission retains authority to determine each utility's authorized debt/equity mix, and a modest shift toward equity offsets that pressure in full. The Commissioners note that the bill omits an explicit capital-structure adjustment that a model contains, and infer from its absence that the Commission is powerless to respond. It is not. That provision was drafted to confer the authority in jurisdictions where it might be doubted; Pennsylvania needs no such grant, because the authority just described is one the Commission already possesses and this bill expressly preserves. Section 1381(j)(4) leaves each utility's authorized capital structure and cost of debt undisturbed as components the Commission continues to set, and Section 1382(l)(11)(i) requires each regulated service to maintain the capital structure the Commission authorizes. The lever our modeling relies upon is thus not merely available to the Commission; the statute affirmatively confirms it.

Our modeling shows that pairing a reduced ROE with a small reduction in leverage leaves every measure the agencies consider — funds from operations to debt, debt to EBITDA, interest coverage, and debt to capitalization — at least as strong as it stands today, and several of them stronger. Credit quality is preserved or improved, using a lever the Commission already controls, while ratepayers keep the great majority of the savings the lower return produces. A rating agency's reaction to a Governor's letter proposing an auction is not a verdict on the design of this bill, which leaves the Commission's capital-attraction obligation — and its ratemaking toolkit — fully intact.

Novelty. That "no jurisdiction has implemented" this is said of every reform until one does — including the airline deregulation that followed those 1975 hearings, which incumbents likewise

called reckless and untested. The bill's building blocks — Treasury-indexed return formulas and uniform-price securities auctions — are each long established. What is new is only their combination, as applied to utilities, and that innovation exists precisely to cure a defect the empirical record now documents beyond serious dispute.

Finally, on the suggestion that this reform is the product of self-interest.

The Commissioners devote much of their letter to MarketClear's motives rather than the bill's merits. A few facts are in order. MarketClear is a bipartisan public policy organization. With a single exception, its senior leadership and advisors — including multiple former state commission chairs — have spent their careers in the utility industry, and it is precisely that experience that has led them to conclude that the prevailing model for setting equity returns is broken. The lone exception is a specialist in the design of new financial markets, brought in for the specific purpose of ensuring that the mechanisms we propose are workable in practice.

The organization is pursuing designation as a 501(c)(3) nonprofit. Contrary to the implication that we are driven by profit, none of our principals are compensated; they have funded the organization's expenses out of their own pockets. We have, it is true, developed an auction platform and an implementation playbook — for the simple reason that a reform of this kind succeeds or fails on execution, and someone has to make it work. But the auction administrator is the Commission's to select, under standards and a process the Commission itself sets (Section 1382(g)); any role for us would have to be won, if at all, through open competition at the lowest qualified price. That is the opposite of an entrenched position. It stands in pointed contrast to the covered utilities themselves, which are legal monopolies — franchises deliberately shielded from competition, and therefore from the one force that reliably disciplines price. Supplying that missing discipline is the entire purpose of HB 2224.

We disclose our interest plainly, because the case for HB 2224 does not depend on trusting us. It depends on trusting the market.

Separately from the Commissioners' letter, we have received many thoughtful questions about the bill and the prospective auction mechanics, which we have gathered into an accompanying FAQ. We hope that you and your colleagues will find it helpful, and we encourage any legislator or staff member with questions to reach out to us directly.

We urge support for HB 2224.

Respectfully,

Joel Hornstein
Executive Director, MarketClear Utility Policy Research
joel@marketclear.org

Mark Ellis
Research Director, MarketClear Utility Policy Research
mark@marketclear.org