Columbia Gas® of Maryland

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UNFAVORABLE House Bill 981
Investor–Owned Public Service Companies –
Base Rate Proceedings – Equity Market Return
House Environment and Transportation Committee

Columbia Gas of Maryland, Inc. (Columbia) opposes House Bill 981 (HB 981), which requires the Maryland Public Service Commission (PSC) in a base rate case to determine a certain equity market return for investor-owned gas, electric or combination gas and electric public service companies using "multiple objective sources" and adjust Return On Equity (ROE) rates based on the risks to the company as compared to the equity market return.

To prepare this testimony, Columbia had HB 981 reviewed by an outside consultant with 25 years of regulatory and capital markets experience in the utility industry who has provided expert testimony in numerous regulatory proceedings before state utility commissions and the Federal Energy Regulatory Commission (FERC). His expertise and experience includes topics such as the cost of equity (ROE), overall fair rate of return, appropriate rate-making capital structure, rating agency considerations, utility recapitalizations, and other financing related matters.

Based on the consultant's review of HB 981, if the legislation was enacted into law, it would likely result in unintended negative consequences for Maryland's utility customers. A number of uncertainties arising from the legislation would likely contribute to a deterioration in the investment risk profile of the state's utility companies. This would then have the unintended consequence of materially increasing the borrowing costs of utilities in the state. These increased borrowing costs would ultimately be passed through to Maryland's utility customers causing utility bills to increase.

The methodological approach for establishing a utility's cost of equity as presented in HB 981 is non-specific and vague, and is therefore subject to differences in interpretation, rendering the bill unworkable.

Columbia's consultant believes the "current average expected 10-year U.S. equity market return" the PSC needs to determine is an unattainable data point because the U.S. and global equity markets are in fact dynamic or constantly changing. Attempting to estimate equity market returns over a forward-looking 10-year horizon using a static, or unchanging model will likely result in cost of equity estimates that bear little resemblance to realized market returns over the forecast horizon.

HB 981 states the PSC shall use "multiple objective sources" to determine the equity market return. However, the legislation does not provide any guidance as to the specific objective sources that would actually be utilized. Moreover, even if such objective measures were to be defined, incorporating those measures into a static formulaic model would be unlikely to reflect ever-changing U.S. equity market conditions, thus resulting in cost of equity estimates that are inconsistent with the prevailing market-based cost of equity.

HB 981 also states the PSC may adjust rates for a public service company based on the risks to the public service company as compared to the equity market return. However, the legislation does not provide any additional guidance or methodology as to how this risk differential would be established. There are in fact multiple factors that bear upon a regulated utility's risk profile relative to the overall U.S. equity market portfolio, and none of those factors are addressed in the legislation.

Over time, HB 981 will almost invariably lead to a deterioration in a utility's credit metrics, which would potentially be followed by one or more credit rating downgrades for the state's utilities. This in turn will result in higher borrowing costs for the utility. Even worse, in challenging capital market environments, such as those seen during the financial crisis and Great Recession of 2007-2009, a utility could even temporarily lose access to the public debt capital markets altogether.

As the members of the Environment and Transportation Committee may realize when reviewing this testimony and HB 981, the issues and concerns that arise with the introduction of the legislation are complex and complicated. In summation, Columbia provides these basic concerns:

- Customers would ultimately pay more because the bill's vague methodology creates investor uncertainty that raises utility borrowing costs.
- Static formulas would misprice real market risk, making it harder for utilities to secure affordable capital needed to maintain safe, reliable service.
- Missing guidance on utility-specific risks would destabilize financial expectations, increasing the cost of delivering essential infrastructure to customers.
- Greater uncertainty could trigger credit downgrades or even restrict access to debt markets driving up financing costs that flow directly to customers.

Most importantly, the proposed legislation departs from historical and widely accepted practices and financial modeling techniques for estimating the cost of equity in utility rate proceedings. The PSC has had a long-standing protocol for establishing ROE that has been vetted over the decades and even tested by the courts. Legislation to abolish the established and proven practices creating a void and replacing it with vague and ambiguous language is not wise public policy making and will be subject to unintended consequences.

Therefore, Columbia Gas cannot support House Bill 981 as appropriately crafted policy for the efficient, effective and affordable operations of investor-owned utilities in Maryland and urges an unfavorable report.

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Contact:
Carville Collins
(410) 847-5598
carville.collins@saul.com

Contact:
Scott Waitlevertch
(724) 888-9774
swaitlevertch@nisource.com