

Fuel Cost-Sharing and Utility Returns

Why Higher ROEs Are Not Justified

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What we will cover

- Power demand, investment needs, and impacts to affordability.
- The status quo: Fuel adjustment mechanisms (FAMs) – how FAMs work and imbalances that they cause.
- Fuel cost-sharing (FCS) – how FCS works and common design features.
- Arguments against transitioning from FAMs to FCS regimes, and counterarguments.
- Key takeaways.

Large investment need in the sector will likely increase costs for ratepayers...

Electricity demand is rising at unprecedented levels...

[S&P Global](#) projects an annual growth rate in the range of 1.9–2.7% through 2034, vs. 0.6% average annual growth rate experienced during the past 2 decades.



... requiring a large investment need...

Industry group [EEI](#) estimates that investor-owned utilities (IOUs) plan to invest \$1.1 trillion between 2025 and 2029, vs. the \$765 billion spent in the prior five years.



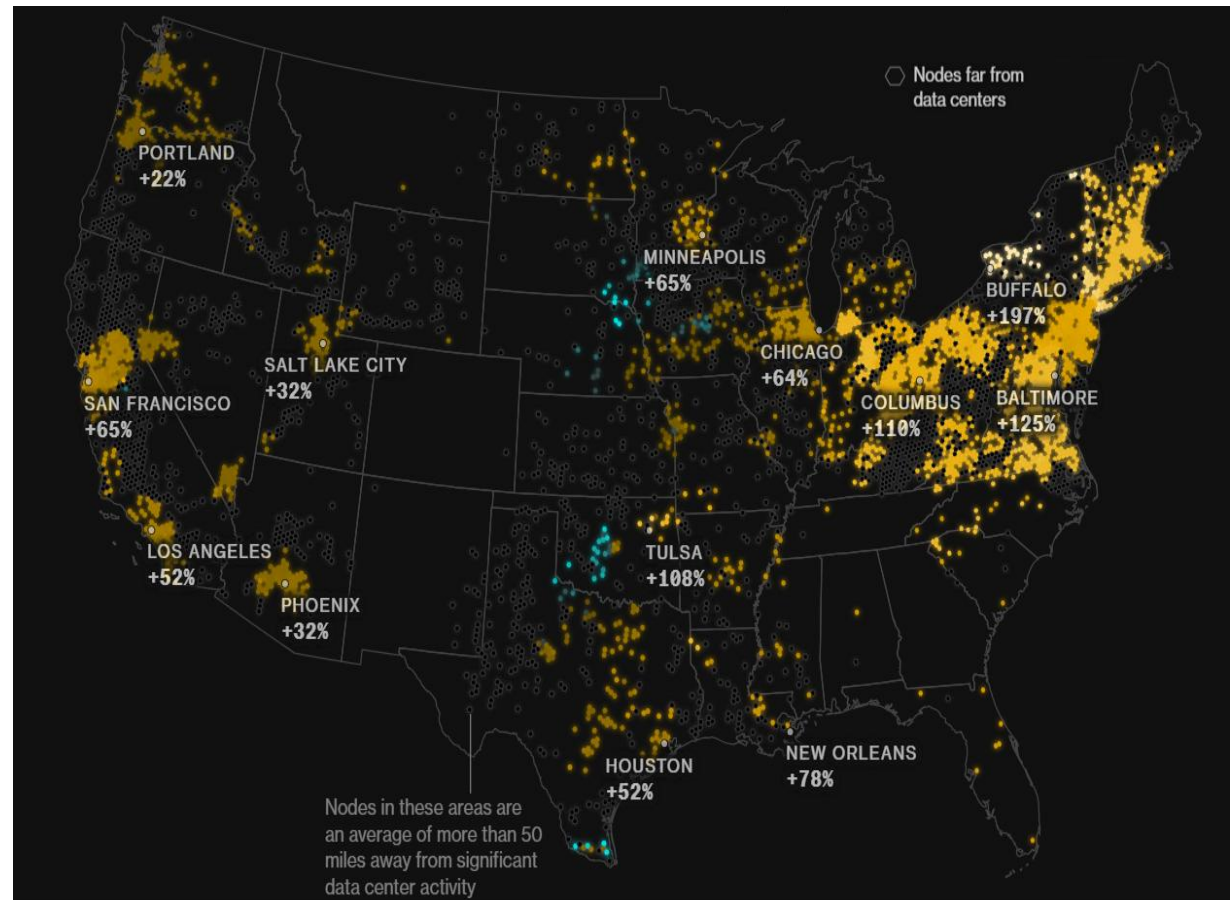
... and driving a surge in ratepayers' costs.

We estimated the \$1.1 trillion investment need represents over \$100 billion annually in financing costs alone.

... at a time when affordability is already a top concern nationally

- [Data Centers Push Power Bills Up 76% on Largest US Grid, Report Shows](#) – Bloomberg, May 2026
- [US Power Prices Climb 61% Faster Than Inflation as Demand Surges](#) – Bloomberg, May 2026
- [San Diego's electric bills are up 50% since 2021](#) – Axios, April 2026
- [Dominion Energy proposes largest rate hike in decades](#) – Fairfax Times, April 2025

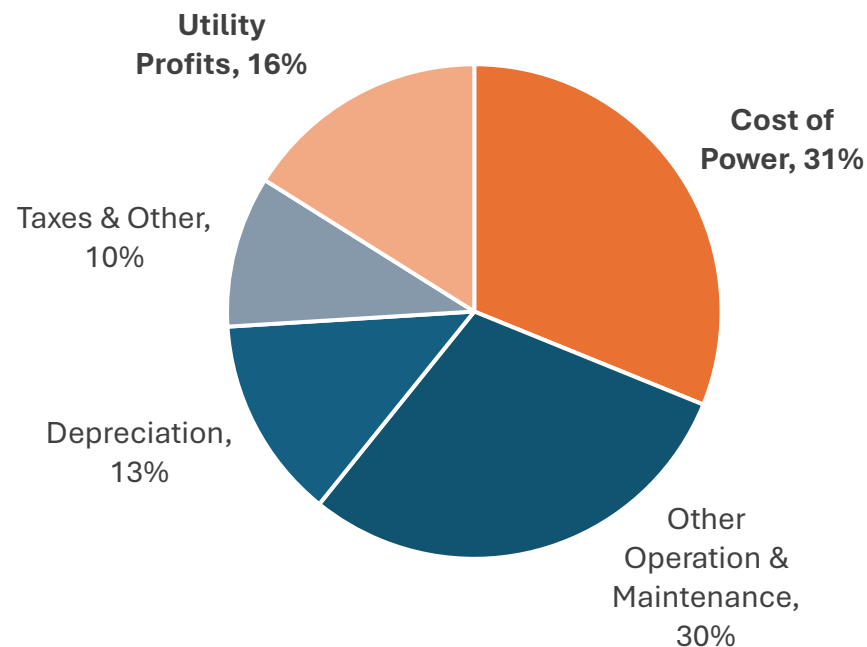
Changes in Wholesale Prices, 2020–2025



Source: Bloomberg News, link to article [here](#).

Fuel cost recovery reform can be part of the toolkit to improve affordability

US Average Electricity Bill Split for Major IOUs (2020-2024)



- Utility profits and the cost of power account for more than 45% of the average customer electricity bill.
- Under current practices, there is no economic incentive for utilities to manage fuel risk.
- This translates into material volatility in customer rates.

Source: Vereda Advisory graphics. Data from the [Energy Information Administration's \(EIA's\) 2024 Electric Power Annual report](#).

Fuel cost recovery – The status quo

- Most regulated electric utilities in the US pass 100% of fuel cost fluctuations directly to customers through **fuel adjustment mechanisms** (FAMs).
- FAMs were implemented half a century ago during emergencies to shield utilities from the volatility inherent in global commodity fuel markets.
- How FAMs work:

A rate case sets base rates using a baseline/assumed fuel cost (from a test year forecast).

That baseline is embedded in the per-kWh base rate and stays fixed until the next rate case.

FAMs allow utilities to periodically reconcile actual fuel costs against the baseline and charge or credit customers any difference outside of rate cases.

The imbalance that FAMs cause

Fuel outcomes are determined not just by fuel prices but also by procurement strategies and resource planning, both fully under utilities' discretion.

- **FAMs create a moral hazard**, a situation in which one party engages in risky behavior or fails to optimize outcomes because it lacks any economic consequence of its behavior.
- **FAMs distort risk allocation in resource planning** when regulators approve new resources based on utilities' own projections, but actual fuel costs deviate from those forecasted.
- **FAMs affect the integrity of competitive procurement processes.**

Fuel cost-sharing

9 states have implemented **fuel cost-sharing** (FCS) policies, and several more are considering the policy change.

What FCS is:

A direct financial stake in fuel cost outcomes: the utility shares overruns and savings with customers, instead of passing 100% of variance through.

E.g., a 90/10 sharing band: customers absorb 90% of a deviation from forecast (a.k.a. baseline), while the utility absorbs 10%.

FCS common design features:

- Deadbands
- Sharing percentages
- Symmetry or asymmetry of sharing
- Caps

FCS mechanisms offer upside, not only downside, for utilities' bottom line

Symmetrical sharing lets utilities keep a portion of **savings**, not just absorb overruns, creating **upside** when costs beat forecasts.

Intervenor Blue Planet in Hawaiian Electric Company Inc. Docket No. 2016-0328 noted that FCS could, “*over time, be as likely to be positive as negative,*” and that a correctly designed policy that incentivizes the move away from volatile fossil fuel resources would consequently reduce potential revenue exposure risk.

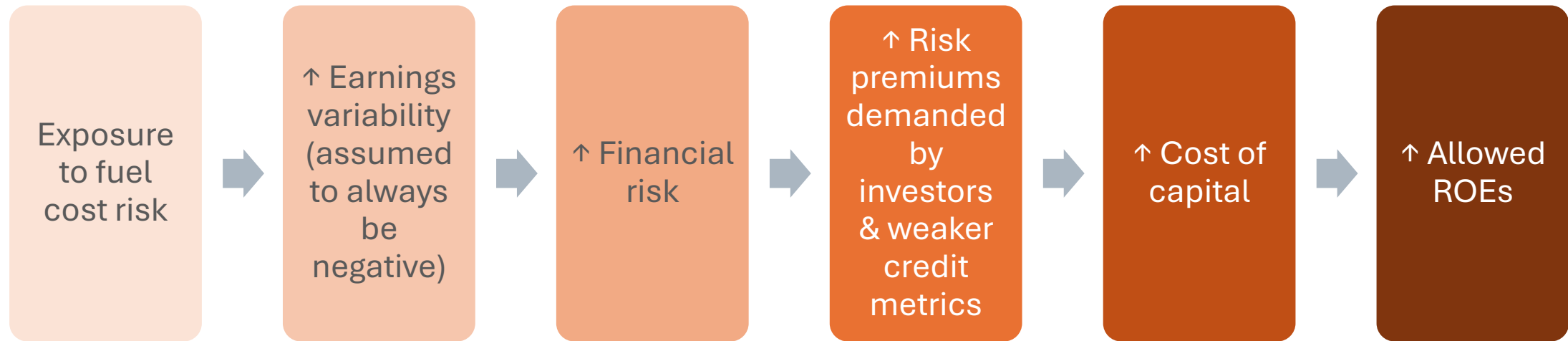
FCS frameworks often broaden recoverable costs to **net power costs** (transmission rights, wholesale sales, ancillary services), not just physical fuel, which can result in a broader insurance policy.

Nonetheless, critics claim two main arguments against FCS mechanisms

Argument 1: Transitioning from a 100% passthrough policy to a fuel cost-sharing regime increases the cost of capital, justifying higher allowed returns on equity (ROEs).

Argument 2: Utilities shouldn't bear risk they don't control.

Argument 1 – From exposure to fuel risk to allowed ROEs



Based on financial theory and a review of regulatory precedents over the past 15 years across 11 states, **our analysis found this claim to be overstated.** Utilities conflate short-term earnings variability (assumed to always be negative) with the market-wide risk that determines the cost of capital.

Argument 1 – Are higher allowed ROEs warranted?

Financial theory suggests they aren't...

- Cost-of-equity models (Discounted Cash Flow, Capital Asset Pricing Model, Risk Premium) price **systematic risk**, market-wide risk investors can't diversify away.
- FCS could indeed cause earnings swings, a risk that is company-specific, also called **idiosyncratic risk**, a risk investors can diversify away, and that is just as likely do work in the utility's favor as against it.

“...the results from the DCF or risk premium models have nothing to do with a utility's operating profit or fluctuations in utility's operating portfolios in the normal course of business.”

– Rocky Mountain Power in Wyoming Docket No. 20000-368-EA-10 (Record No. 12477), 2011

Argument 1 – Are higher allowed ROEs warranted?

...as well as regulatory precedent.

- Only 2 of the 9 states with FCS regimes in place transitioned from a full passthrough to fuel cost-sharing with an ongoing proportional sharing split: Montana and Hawaii, both in 2018.
 - In both cases, **authorized ROEs remained unchanged** despite claims by utilities to increase allowed returns.
- Most other states transitioned from fuel costs being **fixed** in rates (no passthrough) to being shared with ratepayers, **reducing** earnings variability.
 - Interestingly, utilities **didn't** request cuts in allowed returns despite the resulting lower financial risk for them.
 - Vermont (2006) and Missouri (2015) FCS implementations saw accompanying **declines** in allowed ROEs, but these cases are dated (VT) or not useful precedents because of a broader assessment of market risk (MO).

Argument 1 – Are credit metrics weakened?

Credit rating agencies indeed value predictability; however, utilities ignore important nuances:

A) FCS could be positive for the bottom line

- An FCS policy with symmetrical sharing allows utilities to share fuel cost savings, too.
- FCS frameworks tend to broaden the scope of recoverable costs to cover net power costs (transmission rights, wholesale sales, ancillary services).

Argument 1 – Are credit metrics weakened?

Credit rating agencies indeed value predictability; however, utilities ignore important nuances:

B) Rate affordability and flexibility are also key factors in credit ratings methodologies

- Fitch Ratings identifies “rate flexibility” as a key factor, reflecting both the ability to recover costs on a timely basis and the degree to which rates remain affordable for customers.

Argument 1 – Are credit metrics weakened?

Credit rating agencies indeed value predictability; however, utilities ignore important nuances:

C) Utilities remain far from any threshold at which capital access could be impaired

- A 2025 [report](#) found that at an industry-wide market-to-book ratio of ~2.0x, utility assets are valued at a 100% premium.

Argument 1 – Are credit metrics weakened?

Credit rating agencies indeed value predictability; however, utilities ignore important nuances:

D) Utilities have proven their ability to absorb real shocks before

- Under extreme circumstances, such as the COVID-19 pandemic, many utilities absorbed shocks through cost control measures, ultimately delivering earnings growth projections and keeping credit metrics intact.

Argument 1 – Are credit metrics weakened?

Credit rating agencies indeed value predictability; however, utilities ignore important nuances:

E) Policy design features can limit extreme scenarios to ensure utilities' financial stability

- Design features such as caps and earnings tests bound risk exposure, preserving predictability in financial outcomes.
 - Hawaii's energy cost recovery clause (ECAC), applicable to Hawaiian Electric Company, includes a cap for utility exposure.
 - Oregon's earnings test feature links PacifiCorp's ability to credit or charge customers for fuel cost variances to actual ROEs.

Argument 2 – Fuel prices vs. fuel costs

Argument: Fuel prices, determined by global supply-demand dynamics or extreme weather events, are outside utilities' control and therefore they should not bear financial responsibility for variation in **fuel costs**.

Counterargument: Prices are external; outcomes are not. Although spot market prices themselves are uncontrollable, fuel cost outcomes reflect a combination of external conditions and utility risk management choices.

Argument 2 – Fuel prices vs. fuel cost outcomes

What Utilities CANNOT Control: Fuel Prices (\$/MMBtu or \$/ton)

- Global natural gas and power market prices
- Extreme weather events
- Geopolitical supply shocks

What Utilities CAN Control:

- Hedging strategy
- Contract structure and duration
- Procurement timing and storage decisions
- Resource-mix assumptions in long-term planning

Key Takeaways

1. Critics assume FCS-driven earnings variability to always be negative; this is incorrect
2. They also conflate potential short-term operational variability with the market-wide risk that determines the cost of equity.
 - Idiosyncratic risk, such as the one introduced by FCS, may affect existing shareholders' interests but not the mechanics of capital raising.
 - The above is supported by regulatory precedent over the past 15 years.
3. Critics also conflate fuel outcomes with fuel prices, with the former being highly within utilities' control and the latter being determined by global/regional forces.
4. Properly designed FCS policies can be structured to promote least-cost fuel procurement and adequate resource planning while moderating shocks for customers — all without compromising utilities' financial integrity or access to capital.

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