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Before the Ohio House Energy Committee

Support for HB 142

May 14, 2025

Chairman Holmes, Vice Chairman Klopfenstein, Ranking Member Glassburn, and Members of the House Energy Committee:

I respectfully offer the following comments based on my past experience as Managing Director and Senior Investment Analyst at UBS Global Asset Management, Chairman of the Michigan Public Service Commission, Chief Financial Analyst of the Illinois Commerce Commission, Manager, Capital Markets for Sprint Corporation, and Treasurer of the United Telephone Company of Ohio.

I support HB 142 and its goal to reduce regulatory lag. Reducing regulatory lag supports utility investments and reduces the amount of interest ultimately recovered from customers through rate cases. Investors will find Ohio a more attractive state in which to invest utility capital. Utility investment will support economic development and the addition of new large load customers.

HB 142 REDUCES REGULATORY LAG

HB 142 reduces regulatory lag by shortening rate cases, allowing for fully-forecasted future test years, improving riders/trackers, and accommodating large load customers. These features will permit Ohio utilities to better match the timing of revenues and costs, providing a closer match of cost recovery to cost incurrence. Ohio utility customers will benefit when utility cash flow improves, while utility investors will find Ohio a state with more timely cost recovery and a more attractive place to invest capital.

Investors consider rate case timing to be important to minimize regulatory lag. Investors prefer that a state have a statutory deadline on rate case decisions. A set time frame provides a degree of certainty as to when new revenues will be collected. A shorter, more efficient time frame generally enhances the likelihood that the new rates effective during the first year will closely reflect the costs incurred, keeping regulatory lag to a minimum. The goal is to closely match cost recovery with cost incurrence.

About two-thirds of all states commissions nationwide have a rule or statute that requires a rate case to be decided within seven to twelve months. Several states are shorter than seven months and only a few have no limit. Investors consider the length of the time frame as well as the

degree to which the commission adheres to that time frame when assessing regulatory risk. Investors realize that Ohio rate cases currently take a long time to resolve.

The rate case test year is also a key investor consideration. The rate case test year is the twelve-month period used as a baseline in examining the utility's revenues, expenses, investments, and capital structure. The test year options include historical, forecasted, or a hybrid. A fully forecasted test year is generally considered to be most constructive, particularly during periods of robust capital spending.

Investors view the existence of regulatory adjustment mechanisms such as riders and trackers as supportive of utility investment. Adjustment clauses have been growing in usage and importance across the regulatory landscape since the 1970s, especially for infrastructure investment, and have become widely utilized to allow utilities to recover costs in a timelier manner. Investors also focus intently on the details of the mechanisms. Ohio makes use of riders and trackers but many in use in Ohio are lagged and capped so of limited use in mitigating regulatory lag.

A primary business risk to utility investors is regulatory risk. Investors value certainty, stability, and predictability. Regulatory risk is the risk that regulatory actions, including changes in laws or regulations, will materially impact the company by increasing operating costs, reducing the attractiveness of an investment, or change the competitive landscape. Regulatory quality is assessed by investors when judging a utility's risk.

Investors evaluate the regulatory climate because it is an important component of assessing risk and valuing investments in regulated utilities. Tools investors use to form opinions about regulatory risk include meetings with company management, customers, and regulators, as well as credit rating agency and Wall Street analyst research reports, because regulatory climate has a significant impact on utility credit quality and equity valuations.

Utility customers are also looking for certainty, stability, and predictability. Customers benefit from a certain, stable, and predictable regulatory environment that reduces risk and the capital costs that ultimately get borne by customers through rates.

As a result, customers benefit from minimizing regulatory risk. The cost of capital is higher where the utility does not get supportive regulatory treatment. Regulatory lag and regulatory risk increase the cost of capital including debt borrowing costs and equity costs that customers ultimately pay.

This customer benefit is described in the National Association of Regulatory Utility Commissioners (NARUC) "A Cost of Capital and Capital Markets Primer for Utility Regulators" that I authored in 2019. NARUC is a non-profit organization dedicated to representing state public service commissions that regulate the utilities that provide essential services. PUCO is a member of NARUC. On pages 9, the Primer indicates:

> Customers benefit by having a financially stable utility that has the earnings and cash flow sufficient to attract equity and debt on reasonable terms, and the resulting ability to provide safe, reliable, and affordable utility service. Receiving a reasonable authorized ROE and capital structure from regulators is an important contributor to financial stability. The customer benefits that result from being served by a financially healthy utility outweigh the illusory short-term "benefits" of a negative regulatory climate that heightens regulatory risk.

Investors have a fiduciary duty to make investments in jurisdictions with reasonable regulatory treatment. Investors monitor regulatory decisions in more than 50 U.S. regulatory jurisdictions by following commission hearings, reading commission orders, and watching public meetings. Investors then compare investment opportunities across jurisdictions. The capital markets are globally competitive and investors can move investment dollars from state to state relatively quickly. Investors can invest in other industries if they find utilities generally unattractive.

Likewise, utility management has an incentive and a duty to allocate capital where it is treated fairly. For example, neighboring states that compete for capital with Ohio include Indiana, Kentucky, and Pennsylvania. Investors recognize that Ohio's neighboring states provide less regulatory lag than Ohio and expect parent companies, such as NiSource, to allocate capital accordingly.

Investors view Ohio as a middle-of-the-pack average to below average risk jurisdiction where the key negative that holds Ohio back from improvement is regulatory lag.

UTILITY CAPITAL MARKETS

Utilities raise debt and equity capital. Debt (fixed income) investors lend debt capital to utilities. Debt investors expect periodic interest payments and the return of capital at maturity. Each debt instrument has defined terms including the principal amount, interest rate, and maturity date.

Equity investors provide equity capital to utilities and acquire stock which represents an ownership interest in the utility. Equity investors expect periodic dividend payments and stock appreciation upon selling the stock. Of course, stock prices go up and down so equity investors bear the risk of losing money when they sell the stock. Equity has a lower claim on corporate assets, thus is considered higher risk than debt. As a result, equity has a higher cost than debt.

The capital market is built around risk-adjusted returns. Equity investors recognize that utilities have below-market risk and provide below-market returns, as generally recognized by state regulators. Investors that desire above-market returns are generally investing in competitive unregulated industries rather than utility stocks.

State utility regulators, like PUCO, authorize an ROE in rate cases for a utility based on its cost of equity in the capital marketplace. When assessing the relative attractiveness of investing in a state, investors will consider both the level of the authorized ROE and the ability to actually earn the authorized ROE. Regulatory lag is often the primary driver when a utility underearns its authorized ROE.

For example, a utility with an authorized ROE of 10.0% can only earn about 8.4% over the life of a new investment with one full year of regulatory lag. The associated internal rate of return falls to 7.1% with two years or 6.1% with three years of regulatory lag. These lagged returns compare unfavorably to current rates on lower-risk corporate bonds of 6.5% and 4.5% on U.S. Treasury bonds that are generally considered risk-free. In this example, the authorized ROE that is intended to compensate utility equity investors for the risks including construction, operations, general inflation, and supply chain inflation, is degraded by regulatory lag.

The capital structure, or the mix of debt and equity, is reviewed by the PUCO during rate cases. Utilities strive to find the appropriate mix of debt and equity to minimize costs to customers.

UTILITY CREDIT RATINGS

Long-established legal precedents establish that utilities are entitled to a fair return on their assets (rate base). The Hope (1944) and Bluefield (1923) U.S. Supreme Court cases that are the foundational principles of utility regulation both focus on credit quality. Regulatory practice has evolved from these decisions that sets the fair return equal to the weighted average cost of capital.

There are three primary credit rating agencies: Moody's Investor Service, Standard & Poor's Global Ratings, and Fitch Ratings. The credit rating agencies rate debt instruments, including utility debt. The role of the credit rating agencies is to judge the creditworthiness of an entity by identifying risks, then to incorporate those risks into credit ratings. Investors use the credit ratings when making investment decisions. The credit rating agencies are independent referees that call ball and strikes, objective, forward-looking, and do not provide advice or recommendations.

The credit rating agencies rate all kinds of debt including corporate, government, sovereign, and municipal debt. A credit rating incorporates a view of the probability of default and the severity of loss in event of default.

Debt ratings can be divided into investment grade and speculative grade. Speculative grade is also known as high-yield or junk bonds. Utilities aspire to be investment grade, given the capital-intensive nature of the industry, long-lived assets needed to serve customers, and obligation to serve customers.

The full range of credit ratings is from AAA to D, with AAA the highest credit rating and D the lowest. A "+" or "1" is used as a sub-indicator of the upper portion of the rating, while a "-" or "3" is used to indicate the lower portion of the rating.

Most utilities are rated in the A to BBB range. The average utility rating is BBB+. BBB+ is considered a medium investment grade rating, and corresponds to a strong to adequate capacity to meet financial commitments. All utilities strive to be at least investment grade. Most utilities do not strive for AAA because it would require an equity-skewed capital structure that is costly for customers.

The primary risk for the utilities is regulatory risk. The regulatory risks faced by utility investors are important to utility customers. As discussed on page 8 of the NARUC Cost of Capital and Capital Markets Primer for Utility Regulators:

> The risks faced by utility investors are important to utility customers because risks to investors get reflected in the capital costs to the utility which are ultimately paid for by customers. Regulatory risk as perceived by investors impacts the availability and cost of capital. When investors perceive higher risk, the corresponding costs of debt and equity increase. If investors are less willing to provide capital, capital is less cost-effective for customers. For example, rating agency downgrades generally result in higher interest rates on newly-issued debt securities. A utility downgrade would place upward pressure on the embedded cost of debt, as new long-term debt securities are issued at higher interest rates. Additionally, a utility's cost of equity would increase as investors require a higher rate of return to compensate for additional risk.

A credit rating downgrade would place upward pressure on the cost of short-term debt and the embedded cost of long-term debt, as new long-term debt securities would be issued at higher interest rates. Moreover, revolving credit facility sometimes immediately re-price upward to higher interest rates, as lower credit ratings are tied to higher credit spreads. Also, a lower credit rating would also impact the amount of unsecured credit extended by natural gas and wholesale power counterparties as well as their collateral demands. Additionally, the cost of equity would increase as investors would require a higher return to compensate for additional risk. These higher capital costs ultimately are paid for by customers.

The credit rating agencies cite attributes of credit supportive regulation: timeliness of rate orders, use of forward-looking measures, and use of adjustment mechanisms such as clauses/riders/trackers.

The credit rating agencies also cite attributes of challenging regulation: regulatory lag, prolonged rate cases without resolution, historic test years, and caps on recovery.

The following three slides demonstrate the importance of regulation and cash flow to a utility's financial health. These slides were presented by representatives of the three credit rating

agencies as part of the NARUC Regulatory Training Initiative on August 21, 2024. The four broad credit rating agency factors include a qualitative evaluation of regulation and quantitative cash flow metrics.

Industry/ Sector Methodologies

Regulated Electric and Gas Utilities Rating Methodology

- Regulation accounts for half the rating
  - Notching adjustment made for holdco debt and non-utility activity

Factor / Sub-Factor Weighting - Regulated Utilities

Broad Rating Factors	Broad Rating Factor Weighting	Rating Sub-Factor	Sub-Factor Weighting
Regulatory Framework	25%	Legislative and Judicial Underpinnings of the Regulatory Framework	12.5%
		Consistency and Predictability of Regulation	12.5%
Ability to Recover Costs and Earn Returns	25%	Timeliness of Recovery of Operating and Capital Costs	12.5%
		Sufficiency of Rates and Returns	12.5%
Diversification	10%	Market Position	5%*
		Generation and Fuel Diversity	5%**
Financial Strength, Key Financial Metrics	40%		
		CFO pre-WC + Interest/ Interest	7.5%
		CFO pre-WC / Debt	15.0%
		CFO pre-WC – Dividends / Debt	10.0%
		Debt/Capitalization	7.5%
Total	100%		100%

* 10% weight for issuers that lack generation
** 0% weight for issuers that lack generation

Factor 1A: Improvement in US regulatory environment vs. jurisdictions in other countries led to upgrades of most US utilities in 2014.

Factor 1B: Utility-specific regulatory treatment.

Factor 2A: Rate case process, cost recovery mechanisms, regulatory lag;

Factor 2B: ROE (allowed vs. industry average and actual earned), disallowances

Factor 3A: Diversity of economy, regulatory jurisdiction, operations

Factor 3B: Diversity of fuel and generation; scores range from Aa to Ba

Factor 4: Financial metrics accounts for 40% of methodology grid. Cash flow from operations before working capital changes (CFO pre-WC) / Debt ratio most important

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Factor 1 – Regulatory Framework (25%)

- 1a) Legislative and Judicial Underpinnings of the Regulatory Framework (12.5%)
  - Scope, clarity, transparency, credit supportiveness, and granularity of legislation
  - Regulator's authority over rate-making
  - Challenge to electric and gas utilities' monopolies can lower scoring
  - Legislation's responsiveness to needs of the utility and determination of fair rates
- 1b) Consistency and Predictability of Regulation (12.5%)
  - Utility's interactions in the regulatory process and stance of the regulator toward the utility
  - Technical nature and transparency of regulators
  - Level of political intervention
  - Utility's ability to meet its customers and regulators' expectations

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Factor 2 – Ability to Recover Costs and Earn Returns (25%)

- 2a) Timeliness of Recovery of Operating and Capital Costs (12.5%)
  - Cost recovery mechanisms for operating costs and capital expenditures to be trued-up periodically into rates
  - Formula rates, riders and trackers, abbreviated or single-issue rate cases
  - Process/timeframe of rate cases
  - Track record of the utility and regulator's timeliness
- 2b) Sufficiency of Rates and Returns (12.5%)
  - Statutory protections assuring full cost recovery and a reasonable return
  - Regulatory mechanisms used to determine what a reasonable return should be
  - Track record of the utility in actually recovery costs and earning allowed returns

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Regulatory risk permeates the four factors but primarily Factors 1, 2, and 4 (90%). HB 142 directly addresses these factors by reducing Ohio's regulatory lag.

The most challenging factors to Ohio include the timing of rate case decisions, stale test years, and capped riders and trackers that directly impact the ability to recover costs and earn returns (Factor 2) and weaken cash flow (Factor 4). The caps impede and limit the cash flow benefit of the riders and trackers. Cash flow is critical particularly during a time of robust capital spending. The credit rating agencies emphasize that cash flow is king.

SUMMARY

Long rate cases, stale test years, and capped riders and trackers are ways to perpetuate regulatory lag, ensure that the utility will earn a return below the authorized return, and are contrary to the public interest because they imposes additional costs on customers in the long-run.

My concern is that the continuation of regulatory lag, long rate cases, stale test years, and caps on riders and trackers would demonstrate to investors that their investment dollars are not welcome in the state of Ohio. Instead, HB 142 will move Ohio regulation more in the range of neighboring states by advancing Ohio's regulatory framework and contribute to the financial strength of Ohio gas utilities.

Moreover, the bill advances the growth of large load customers while protecting existing customers. Investors recognize the significant opportunity of new large load customers but also recognize the corresponding risk. HB 142 offers the right balance and provides financial certainty to investors and existing customers.

During my time investing in the utility industry at UBS, I considered regulatory risk and regulatory lag of utmost importance in selecting which utility stocks to buy or sell. I monitored states for potential increases and decreases in regulatory lag that impacted their relative attractiveness.

One current example of a state where utilities are getting downgraded by the credit rating agencies caused by an adverse regulatory environment and increased regulatory lag is Connecticut. As a result, utilities have announced the shift of investment dollars away from Connecticut toward neighboring states including Massachusetts and New Hampshire.

Ohio gas utilities are not immune from credit downgrades related to regulatory lag. For example, East Ohio Gas was recently downgraded by Fitch on April 25 and had its outlook changed from stable to negative by Moody's, also on April 25. Fitch cites weak cash flow metrics due to the lack of a regulatory resolution to address the timing of the recovery of a substantial capex-driven deferral balance, causing a mismatch between when investments are made and recovery is achieved. Moody's also weak references cash flow metrics as well as the lack of a specific statutory deadline for PUCO to reach a rate case decision.

During my time at the Illinois Commerce Commission and the Michigan Public Service Commission, we took proactive steps to create the perception that Illinois and Michigan were welcoming to utility investment dollars that contribute to economic development. HB 142 provides Ohio with an opportunity to join neighboring states in incenting utility investment.

In my opinion, it is best that Ohio not maintain the status quo that provides a disincentive to invest in Ohio ironically at a time of significant economic development opportunity.

In that regard, HB 142 will enhance Ohio's reputation in the investment community, provide long-term benefits to customers, enhance economic development, and proactively accommodate large load customers while maintaining customer protections.

ABOUT JQ RESOURCES, LLC

JQ Resources, LLC assists clients with utility regulatory matters, provides strategic advice, and researches and communicates complex regulatory issues while bridging the gap between the regulatory and investment communities. Its President, John D. Quackenbush, CFA, offers a unique balanced combination of state regulatory leadership, investment sector knowledge, and financial experience in transitional industries. John has served as Chairman of the Michigan Public Service Commission, Chief Financial Analyst at the Illinois Commerce Commission, and Managing Director and Senior Financial Analyst at UBS Global Asset Management, as well as in several management positions in the telecommunications industry.

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