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Decision 00-12-062 December 21, 2000

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

IN THE MATTER of the Application of SIERRA PACIFIC POWER COMPANY, for authority to establish authorized rate of return on common equity for electric distribution for Year 2001. (U 903 E)	Application 00-05-018 (Filed May 8, 2000)

David Norris, Attorney at Law, for Sierra Pacific Power Company, applicant.
James Weil, for Aglet Consumer Alliance; Ron Knecht for Advocates for the Public Interest; and Shirley Woo, Christopher Warner, and Andrew Niven, Attorneys at Law, for Pacific Gas and Electric Company, interested parties.
Robert C. Cagen, Attorney at Law, for the Office of Ratepayer Advocates.

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OPINION

I. Summary

Sierra Pacific Power Company (Sierra) is authorized a 10.80**%** Return on Common Equity (ROE) for its 2001 test year. This authorized ROE results in a corresponding 9.01% return on rate base, 58 basis points[1] lower than the 9.59% ROE that was last authorized Sierra. This change in ROE applied on Sierra's 2001 projected California distribution rate base results in a $562,000 reduction in its 2001 test year California electric revenue requirement. This revenue requirement reduction averages approximately $1.06 a month when divided by Sierra's 44,100 total California customers. Because Sierra's rates are currently frozen, there will be no impact on the total rates that Sierra's customers are billed until Sierra's rate freeze ends. For this purpose, Sierra should use its 2001 rate base set forth in its Cost of Service and Performance-Based Ratemaking (PBR) Application (A.) 00-07-001. Sierra should true-up its distribution rate base to reflect that rate base subsequently adopted in its cost of service and PBR application.

Sierra is required to adjust its authorized revenue requirement to reflect the ROE being adopted in this decision and to adjust its rate components associated with the change in revenue requirement by an advice letter filing.

We also adopt a trigger mechanism that will replace Sierra's annual cost of capital filing as set forth in the body of this decision.

[1] One basis points equal 0.01%.

The 2001 adopted capital structure for Sierra is summarized as follows:

	Ratio	**Cost**	**Weighted Cost**
Long-Term Debt	47.56%	7.47%	3.55%
Preferred Stock	7.67	8.10	0.62
Common Equity	44.77	10.80	4.84
Total	100.00%		9.01%

This compares with the following capital structure and weighted cost of capital last authorized for Sierra:

	Ratio	**Cost**	**Weighted Cost**
Long-Term Debt	44.12%	7.77%	3.43%
Preferred Stock	8.84	8.00	0.70
Common Equity	47.04	11.60	5.46
Total	100.00%		9.59%

II. Jurisdiction

Sierra, a Nevada corporation, is a wholly-owned subsidiary of Sierra Pacific Resources, also a Nevada corporation. Sierra is a public utility electric corporation subject to the jurisdiction of this Commission as defined in Pub. Util. Code § 218.[2] Approximately 39,100 of Sierra's 44,100 electric customers are residential customers. The territory in which Sierra operates is primarily mountainous with elevations from 5,000 to 8,000 feet. The service territory includes the counties in the Tahoe Basin, with about 88% of the land being

[2] All statutory references are to the Public Utilities Code unless otherwise stated.

owned by the federal or state governments which falls under the jurisdiction of the Lake Tahoe Basin Management Unit of the U.S. Forest Service. Sierra's California electric operations equate to approximately 8% of its annual electric revenues. Sierra also provides gas, electric, and water services in other states. This application was filed pursuant to Rules 23 and 42 of the Commission's Rules of Practice and Procedure (Rules) and Decision (D.) 96-12-084, dated December 20, 1996.[3]

III. Request

This cost of capital application is Sierra's first filing in five years since the Commission approved a proposed merger between Sierra and the Washington Water Power Company in which Sierra reduced its rates to California customers by $3.1 million and froze those rates through December 31, 1999. As a result of a second decision on the merger, D.96-05-059, Sierra reduced rates by an additional $2.3 million effective June 1, 1996 and froze those rates through 1999. Because the merger collapsed in June 1996, Sierra and Office of Ratepayer Advocates (ORA) petitioned the Commission for an order affirming the provisions of D.96-05-059 and extending the rate freeze through 2000. In D.96-12-084, the Commission approved the joint petition and ordered Sierra to file a cost of capital application by May 8, 2000 for implementation on January 1, 2001.[4] This application is timely filed.

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[3] 70 CPUC2d 455 at 459 (1996).

[4] As discussed more fully below, D.97-12-093 extended the rate freeze for Sierra, pursuant to Assembly Bill (AB) 1890 (Ch. 854, Stats. 1996). This decision did not alter Sierra's requirement to file a cost of capital application.

Sierra seeks authority to increase its 2001 test year ROE from 11.60% to 12.00% for its electric utility distribution operations. Approval of Sierra's 2001 requested ROE would result in a decrease in its overall California rate of return on rate base by five basis points from 9.60% to 9.55% for its electric distribution operations. Sierra also seeks authority to establish an automatic trigger mechanism to adjust its ROE on an annual basis.

IV. Proceeding Type

Sierra requested that this application be classified as a ratesetting proceeding within the meaning of Rule 5(c). The Commission preliminarily found in Administrative Law Judge (ALJ) Resolution 176-3040, dated June 8, 2000, that this proceeding is a ratesetting proceeding and that hearings may be held. This ratesetting classification was subsequently affirmed in the Assigned Commissioner's July 20, 2000 Scoping Memo and Ruling.

V. Prehearing Conference

A Prehearing Conference (PHC) was held on Sierra's application before assigned Commissioner Carl W. Wood and ALJ Galvin in San Francisco on June 29, 2000. The PHC was held to identify and clarify the issues in this proceeding, to deal with procedural matters, and to set dates for an evidentiary hearing.

Appearances were received from Sierra, Aglet Consumer Alliance (Aglet), Advocates for the Public Interest (API), and the ORA.

VI. Presiding Officer and Scope of Proceeding

A Scoping Memo and Ruling was issued by the assigned Commissioner that, among other matters, designated ALJ Galvin as the principal hearing officer, established an evidentiary hearing schedule, established a service list, and determined the scope of this proceeding. It also authorized parties to update long-term debt and preferred stock costs to reflect the result of the October 2000 "DRI" 30-year Treasury Bonds forecast for 2001.

The issues to be addressed in this proceeding are capital structure, interest rate changed and forecast, common equity, rate base return, financial modeling, risk factor, and an automatic trigger mechanism.

VII. Customer Notice

Sierra provided notice of this cost of capital application to its customers, and to the cities, counties, and the state affected by its application, as required by Section 454 and Rule 24 of the Commission's Rules of Practice and Procedure. Sierra did this through mail notices to affected cities, counties, and the state, and bill insert notices to customers. Notice of the application was also included in various newspaper publications throughout California.

VIII. Evidentiary Hearings

Evidentiary hearings were held on September 18**,** 19, 20, and 21, 2000. This proceeding was submitted upon receipt of reply briefs on October 23, 2000.

The assigned Commissioner attended the PHC. The assigned ALJ presided over the evidentiary hearing. A final decision in this matter is being issued well within the 18-month statutory time period set forth in SB 960 (Stats. 1996, Ch.856, §1).

IX. A Fair Return

The legal standard for setting the fair rate of return has been established by the United States Supreme Court in the Bluefield and Hope cases.[5] The Bluefield decision states that a public utility is entitled to earn a return upon the value of

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[5] The Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944) and Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia, 262 U.S. 679 (1923).

its property employed for the convenience of the public and sets forth parameters to assess a reasonable return. Such return should be equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings attended by corresponding risks and uncertainties. That return should also be reasonably sufficient to assure confidence in the financial soundness of the utility, and adequate, under efficient management, to maintain and support its credit, and to enable it to raise the money necessary for the proper discharge of its public duties.

The Hope decision reinforces the Bluefield decision and emphasizes that such returns should be sufficient to cover operating expenses and capital costs of the business. The capital cost of business includes debt service and stock dividends. The return should also be commensurate with returns available on alternative investments of comparable risks. However, in applying these parameters, we must not lose sight of our duty to utility ratepayers to protect them from unreasonable risks including risks of imprudent management.

Sierra seeks a ROE of 12.00% for its electric distribution system, an increase of 0.40% from 11.60% last adopted in 1996. The first step in determining a fair ROE is to establish a reasonable capital structure.

X. Capital Structure

Capital structure is comprised of long-term debt, preferred stock, and common equity.[6] Because the level of financial risk that Sierra faces is determined in part by the proportion of its debt to permanent capital, or its

[6] Excludes short-term debt.

leverage, the concern is to ensure that the adopted equity ratio is sufficient to maintain reasonable credit ratings and to attract capital.

All common stock is issued at the holding company level. For the purpose of rate making, a percentage of Sierra's capital is allocated to each of its three distinct utility businesses or divisions based upon each division's contribution to rate base. These utility divisions are electric, gas and water. After a percentage of capital is allocated to each division, specific amounts of debt, preferred stock and common equity are then assigned to each division. First, a specific amount of debt is assigned to the Water Division. After the debt portion of capital is assigned, preferred stock and common equity are then added in the appropriate proportions to fill out the total capital allocation for the Water Division.

Next, a specific amount of debt is allocated to the Gas Division. After the debt portion of capital is assigned, preferred stock and common equity are then added in the appropriate proportions to fill out the total capital allocation for the Gas Division. Because the individual capital assignments to each utility Division adds up to the total company, the residual amounts of debt, preferred stock, and common equity are allocated to the Electric Division.

Sierra finances its capital requirements with the goal of obtaining the lowest cost of capital at the Company level while maintaining a "A" bond rating, regardless of how that capital is subsequently allocated or assigned to each utility business.

Sierra's allocation of its total company capital to its Electric Division results in a capital structure composed of 47.56% debt, 7.67% preferred stock, and 44.77% common equity. Although Sierra's holding company is seeking federal regulatory approval for a merger with Portland General Electric Company and intends to sell its water operations, Sierra does not anticipate any change in its capital structure. This undisputed capital structure is the same capital structure being proposed by ORA. No other party addressed the reasonableness of Sierra's capital structure.

We conclude that, Sierra's 2001 capital structure consisting of 47.56% long-term debt, 7.67% preferred stock, and 44.77% equity is consistent with the law, in the public interest and should be adopted. The next step in determining a fair ROE is to establish reasonable long-term debt and preferred stock costs.

XI. Interest Rate Increases and Forecast

The forecasted long-term debt and preferred stock costs are based on Sierra's actual, or embedded, costs. However, because we establish the cost of capital on a forecast basis each year, future interest rates must be anticipated to reflect projected changes in Sierra's long-term debt and preferred stock caused by the issuance and retirement of long-term debt and preferred stock during the year.

Sierra's Electric Department assigned debt and preferred stock has fixed contractual estimates. The cost of long-term debt for Sierra reflects a weighted average cost, adjusted to reflect applicable premiums or discounts, and issuance costs. Sierra has forecasted that its test year long-term debt cost for 2001 would be 7.47%.

Sierra estimated its embedded preferred stock by weighting its average embedded cost, adjusted to reflect new issuance costs and any applicable premium or discount. Sierra forecasted that its test-year preferred stock cost for 2001 would be 8.10%.

ORA utilized the same cost of long-term debt and preferred stock in its prepared testimony that Sierra proposed in its application. No other party addressed the reasonableness of Sierra's proposed cost of long-term debt or preferred stock.

Prior cost of capital proceedings generated a considerable debate on the validity of various interest rate forecasts and on the appropriate methodology for equating forecast utility bond rates to other bond ratings. However, in D.90-11-057,[7] we recognized that actual interest rates do vary and that our task is to determine the "reasonable" cost of debt rather than an actual cost based on an arbitrary selection of a past figure. We concluded that the latest available DRI forecast should be used to determine the embedded debt cost in cost of capital proceedings. Consistent with this conclusion, the assigned Commissioner's Scoping Memo and Ruling instructed all parties that long-term debt and preferred stock costs should be updated to reflect the October 2000, DRI Interest Rate Forecast for 30-year Treasury Bonds.

Sierra appropriately updated its long-term debt and preferred stock costs, but the result of this update did not change its forecasted long-term debt cost or preferred stock cost. No party objected to the updated long-term debt and preferred costs. The recommended 7.47% long-term debt and 8.10% preferred stock costs should be adopted. Having determined the appropriate long-term debt and preferred stock costs we now address the appropriate ROE for Sierra.

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[7] 38 CPUC2d 233 at 242 and 243 (1990).

XII. Return on Common Equity

At issue is the appropriate ROE for Sierra's electric distribution operations for 2001. The following tabulation summarizes the ROE position of each party.

Party	Recommended Return
Sierra	12.00%
Aglet	10.60
API	10.50
ORA	10.60

We attempt to set the ROE at a level of return commensurate with market returns on investments having corresponding risks, and adequate to enable a utility to attract investors to finance the replacement and expansion of a utility's facilities to fulfill its public utility service obligation. To accomplish this objective we have consistently evaluated analytical financial methods and risk factors prior to arriving at a fair ROE.

A. Financial Modeling

Historically, quantitative financial models are used as a starting point to estimate a fair ROE. The models commonly used in the cost of capital proceedings are the Capital Asset Pricing Model (CAPM), Discounted Cash Flow Analysis (DCF), and Market Risk Premium (MRP). Detailed descriptions of each financial model are contained in the record and are not repeated here.

Sierra, API, and ORA, each of which used different assumptions and numbers to run their financial models, presented CAPM, DCF, and MRP financial models in this proceeding. The financial models are used only to establish a range from which the parties apply their individual judgment to determine a fair ROE. Although the parties agree that the models are objective, the results are dependent on the subjective inputs. From these subjective inputs the parties advance arguments in support of their respective analyses and in criticism of the input assumption used by other parties. These arguments will not be addressed extensively in this opinion, since they do not alter the model results.

Aglet opted not to use the traditional financial models. Instead, Aglet used Pacific Gas and Electric Company's (PG&E) 1999 authorized ROE as a base and adjusted that base with upward and downward adjustments. The upward adjustments consisted of a 55 basis point adjustment to reflect an increase in interest rates, and a 10 basis point adjustment to reflect increased risk that faces Sierra's investors because of the company's smaller size, lower credit ratings, and individual variations in capital structure. The downward adjustments consisted of a 45 basis point adjustment to reflect the return to PG&E's credit quality single-A stable rating, and a 20 basis point reduction to reflect decreased risk from other risk factors. Aglet thus proposes an ROE of 10.60%.

The following tabulation summarizes the 9.30% - 12.90% broad ranges of results derived from the various quantitative financial models used by Sierra, API, and ORA:

Party	CAPM	DCF	MRP
Sierra	11.30-11.60%	11.80-12.90%	9.90-11.70%
API	10.22	10.51	10.73
ORA	9.30	11.12	11.22

B. Risk Factors

Sierra fine-tuned the results of its financial models to reflect informed judgment with respect to financial, business, and regulatory risk expected to occur in 2001 to arrive at its recommended ROE.

Financial risk is tied to the utility's capital structure. The proportion of its debt to permanent capital determines the level of financial risk that a utility faces. In general, the lower the proportion of a utility's total capitalization consisting of common equity, the higher the financial risk. Therefore, as a utility's debt ratio increases, a higher ROE may be needed to compensate for that increased risk.

Business risk is defined to be the degree of variability in operating results. That is, a company that has the most variability in operating results has the most business risk. An increase in business risk can be caused by a variety of events which include, but are not limited to, deregulation; poor management; a failed marketing campaign; fire in a factory; and, greater fixed costs in relationship to sales volume.

Regulatory risk pertains to new risks that may result from future regulatory action that this and other regulatory agencies might take. It also includes the potential disallowance of operating expenses and rate base additions.

1. Performance Based Rate Making

Included in Sierra's requested 12% ROE is 30 basis points due to its projected impact of the PBR mechanism being requested by a separate application, A.00-07-001 filed in July 2000. Aspects of Sierra's proposed PBR include a revenue sharing mechanism exposing the shareholder to variations in earned rate of return, a revenue index mechanism requiring an annual productivity increase of 1.6% to stay in step with inflation, and a service performance mechanism penalizing shareholders for declines in service quality.

Sierra contends that a PBR mechanism carries its own set of risks, relative to traditional rate of return rate base regulation. Sierra identified three examples of major risk under a PBR mechanism. First, investors and ratepayers would not be protected from the risks that the company's financial integrity is compromised by possible inadequacies in the PBR parameters, such as the inflation index and the productivity threshold. Second, financial performance would become more volatile and unpredictable compared to orthodox rate of return regulation where investment recovery was relatively assured and stable, predictable returns were provided. Finally, each index component of the PBR formula would carry its own risk. In the case of the inflation component, one risk factor involves the relative input factor composition in the aggregate inflation index compared to Sierra's own input factor composition, resulting in a lack of conformity which introduces "index risks" so that year-to-year company profits become statistically more volatile.

Aglet, API, and ORA oppose Sierra's proposed adjustment to the financial models for risk associated with PBR because the history of authorized returns on equity and investor expectations already include investor consideration and expectation of PBR risks.

Sierra, in identifying its examples of major risk under a PBR mechanism, acknowledged that a PBR mechanism substitutes one set of complex risk issues for another. No party in this proceeding attempted to identify or separate utilities included in their respective financial model study groups which utilize PBR mechanisms or attempted to quantify differences in risks and benefits between utilities with and without PBR mechanisms.

By D.94-11-076 we concluded that little or no weight should be given to diversifiable risks and that general economic factors such as interest rates and financial market trends carry more weight than risks associated with individual utilities or utility industries.[8] By that same decision we found that PBRs revise the incentives inherent in cost of service regulation in order to better align shareholder and ratepayer interests which provide well-crafted incentives for shareholders and ratepayers and do not require any risk premium.[9]

All parties agreed in theory that diversifiable risks are not compensated in ROEs granted to a regulated industry. Further, ORA has identified, and Sierra has confirmed, that a PBR mechanism is a mechanism that can be diversified away by investors. No party has presented evidence to justify a reversal of our long-standing policy of excluding diversifiable risks from consideration of a fair ROE. Sierra's proposal to increase its ROE by 30 basis point for risks associated with a PBR mechanism upon adoption of such a mechanism currently under consideration for Sierra in A.00-07-001 is without support and should be denied.

2. Flotation Cost

Sierra includes a 30 basis point upward adjustment in its proposed ROE to reflect the impact of flotation cost. Flotation costs represent the direct and indirect costs of issuing new stock. Direct costs commonly include underwriter costs for marketing, consulting, printing and distributing a

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[8] 57 CPUC2d 533 at 550 (1994).

[9] Id. at 556.

prospectus, legal costs, and discounts that must be provided to place the new stock.

The merits of a flotation cost adjustment were considered and rejected in a prior cost of capital proceeding involving the major California gas and electric companies and Sierra. At that time we concluded that any merit to a flotation adjustment would apply only to existing stock at the time of actual new issuance's and not to sales in the secondary market. We also concluded that such an adjustment is inappropriate as long as utility stocks are trading significantly above their book value. We further concluded that any reconsideration of a flotation adjustment in a future proceeding would require a showing of theoretical and practical utility and market specific data, and a showing that a flotation cost adjustment does not shift the burden of the transaction costs from investors to ratepayers. At such a time, we would consider referring the flotation adjustment to a workshop.[10]

Sierra does not anticipate issuing any new stock in the 2001 test year. Sierra has also confirmed that nothing with respect to flotation cost has changed since the last Commission decision denied the use of flotation costs, and has not submitted the necessary showing set forth in D.92-11-047 and summarized in the prior paragraph. Sierra has not met its burden of proof to justify the inclusion of its proposed 30 basis point flotation cost adjustment to its authorized ROE.

C. Conclusion

We will not approve Sierra's requested 11.70% ROE for its California electric distribution operations under traditional regulation or requested 12.00%

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[10] 46 CPUC2d 319 at 362, and 406, (1992).

ROE upon adoption of its proposed PBR mechanism. This ROE would provide Sierra's shareholders with an excessive return on equity. By excluding the upward flotation cost adjustment from Sierra's CAPM, DCF, and MRP financial models based on electric utility and gas distribution industries and excluding the upward flotation cost and PBR risk premium adjustments from its requested ROE, Sierra's subjective financial models support a 11.40% ROE without any further adjustments.

This ROE is 80 basis points higher than the 10.60% ROE being recommended by Aglet and ORA. We observe that ORA's subjective inputs to financial models similar to those used by Sierra did not include any premium for additional risk associated with PBR or flotation costs. Sierra's adjusted 11.40% ROE is also 90 basis points higher than the 10.50% ROE being recommended by API based on API's subjective inputs to similar financial models and inclusion of a partial premium for flotation costs.

As addressed in our financial modeling discussion, parties derived different results because of their use of subjective inputs. For example, each party used different proxy groups, risk-free rates, betas, market risk premiums, growth rates, calculations of historical market returns, and time periods within their respective models. Although each party addressed the strengths of their respective financial modeling results, other parties addressed their defects. Other than excluding from Sierra's financial modeling results its MRP analyses and upward risk premium for PBR and flotation costs, we have no reason to exclude or adopt the financial modeling results of any one party. Hence, we will establish a range from which the parties applied their individual judgement to determine a fair ROE for Sierra.

Sierra's recommended 12.00% ROE should be adjusted downward to exclude its 30 basis points PBR risk premium and 30 basis points flotation costs risk premium. This reduces Sierra's 12.00% ROE to 11.40% ROE (12.00% less: 0.30% PBR risk premium and the 0.30% flotation cost risk premium). The results of Sierra's MPR analysis should also be excluded for Sierra's failure to identify proprietary MPR data in its testimony and exhibits and failure to provide parties access to verify the reasonableness of the data results to prepare cross-examination questions or rebuttal testimony as required by Section 1822. However, this MPR exclusion has no material impact on Sierra's overall recommendation.

The maximum ROE based on Sierra's financial models adjusted for exclusion of PBR and flotation costs premium risks should be 11.40%. The median ROE recommendation of API, Aglet, and ORA is 10.60%. Hence, a subjective range of ROE for Sierra is between 11.40% and 10.60%.

Parties, including Sierra, ORA and Aglet, state that the Commission has consistently authorized Sierra a ROE that was 10 basis points higher than the ROE granted the major energy utilities. This 10 basis points premium allegedly exist to compensate Sierra's investors for the smaller size, lower credit rating, and individual variation in capital structure in comparison to the major energy utilities. Aglet attempted to substantiate this 10 basis points assumption in a tabulation that showed authorized ROEs for the test years 1991, 1993, and 1994 in its brief. However, in 1993, Sierra was authorized an 11.95% ROE in comparison to PG&E's 11.90% ROE, a five basis points differential. More recently, in 1996 both Sierra and PG&E were authorized the same 11.60% ROE.[11] This 10 basis points ROE premium above the major energy utilities authorized ROE has not been justified and should not be adopted for Sierra in this proceeding.

In the final analysis, it is the application of judgment, not the precision of financial models, which is the key to selecting a specific ROE estimate within the range predicted by analysis. We affirmed this view in D.89-10-031,[12] which established rates of return for GTE California, Inc. and Pacific Bell, noting that we continue to view these financial models with considerable skepticism.

We consistently consider the current estimate and anomalous behavior of interest rates when making a final decision on authorizing a fair ROE. In PG&E's 1997 cost of capital proceeding we stated "Our consistent practice has been to moderate changes in ROE relative to changes in interest rates in order to increase the stability of ROE over time."[13]

The parties are at odds on whether Treasury bonds or AA utility bonds should be used as a benchmark in establishing a fair ROE. In past Commission decisions, the Commission referenced 30-year Treasury bonds and AA utility bond interest rates as benchmarks for evaluating cost of common equity for electric utilities. In the 1999 cost of capital order,[14] the Commission discussed evidence on the historic spread between authorized ROE and 30-year Treasury bond rates from test years 1990 to 1998, before deciding that AA utility bonds

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[11] 62 CPUC2d 480 at 485 (1995).

[12] 33 CPUC2d 43 (1989).

[13] D.97-12-089, mimeo, p.12. (1997).

[14] 196 P.U.R. 4th, 438.

provide a better benchmark for setting the ROE. In the recent ROE application of San Diego Gas & Electric Company (SD&E) and other major energy utilities,[15] we continued to rely on AA utility bonds during a period of time that the DRI forecast for 30-year Treasury bonds dropped during a tremendous turmoil in the foreign markets. At this time investors were fleeing to the safety of U.S. Government backed securities, resulting in Treasury rates falling to unusual low rates in comparison to AA utility bonds.

In this proceeding proponents of the use of Treasury bonds, including ORA, assert that Treasury bonds are a better benchmark than AA utility bonds because of major shifts in the behavior of Treasury bonds within the last few years. While there has been a dramatic variation in the recent forecast of treasuries and AA utility bonds, both instruments continue to reflect changes in interest rate forecasts. In those situations where AA utility bonds demonstrate an erratic change in forecast, less reliance should be placed on that forecast and more reliance should be placed on other interest rate forecasts whether it be treasuries or some other interest rate measurement.

Consistent with our practice to moderate changes in ROE relative to changes in interest rates we compare the most recent trend of DRI interest rate forecasts between the date that testimony was prepared in April to the date this matter was submitted in October, 2000. The October 2000 DRI AA utility bond forecast for 2001 of 7.48% is 28 basis points lower than its April 2000 AA utility bond forecast of 7.76% for 2001. At the same time, the October 2000 DRI 30-year treasury bond forecast of 5.80% is 21 basis points lower than its April 2000

[15] D.99-06-057, mimeo, p.49 (1999).

30-year treasury bond forecast of 6.01% for 2001. Similarly, the October 2000 DRI 10-year treasury forecast for 2001 is 5.71% or 51 basis points lower than its April 2000 10-year treasury forecast of 6.22% for 2001.

Irrespective of whether the AA utility bonds or a Treasury forecast is used to moderate changes in ROE relative to changes in interest rates, the interest rate trend is downward. There is a seven basis point difference in a change in interest rates between AA utility bond rates and 30-year treasuries and a 23 basis points difference in a change in interest rates between AA utility bond and 10-year treasuries.

After considering the evidence on the market conditions, trends, interest rate forecasts, quantitative financial models, risk factors, and interest coverage presented by the parties and applying our informed judgment, we conclude that 10.80% is just and reasonable ROE for Sierra. This ROE found reasonable for Sierra is based on the 11.00% midpoint of Sierra's adjusted 11.40% ROE and interested parties' average 10.60% ROE, adjusted downward by 20 basis points to reflect the current downward trend in interest rates for the 2001 test year. The 20 basis points downward adjustment is consistent with the Commission's practice of adjusting ROE's by one half to two-thirds of the change in the benchmark interest rate.[16]

XIII. ROE Implementation

Sierra recommended that the revenue requirement change being authorized by this decision be combined with the results of its cost of service and

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[16] See for example Re: San Diego Gas and Electric Company et al. D.99-06-057, mimeo., page 50 (1990), and Re: Sierra Pacific Power Company, 57 CPUC2d 533 at 549 (1994).

PBR application into one decision so that changes can be implemented in 2001. Sierra's rates were first set by D.96-12-084 pending the implementation of a new ROE and a PBR on January 1, 2001.[17] Subsequently, D.97-12-073[18] modified the rate freeze to conform with Assembly Bill 1890, which sets forth the framework under which California's electric corporations will move toward and function within a restructured electric industry.

It is not feasible to pass on to Sierra's ratepayers the benefit of a revenue requirement reduction while Sierra's rate freeze remains in effect. Absent a revenue requirement reduction, Sierra's energy charges to ratepayers would now be based on an excessive revenue requirement and violate the Bluefield and Hope cases which entitles Sierra the opportunity to earn a fair and reasonable, not an excessive, ROE. Until such time that Sierra's rate freeze ends, Sierra should adjust its authorized revenue requirement to reflect the ROE being adopted in this decision and adjust its rate components associated with the change in revenue requirement by an advice letter filing. For this purpose, Sierra should use its distribution rate base set forth in its cost of service and PBR application and true-up its distribution rate base to reflect that rate base subsequently adopted in its cost of service and PBR application.

XIV. Automatic Trigger Mechanism

Sierra has requested authority to replace its annual cost of capital filing with an automatic trigger mechanism to free up its staff resources and lessen

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[17] 70 CPUC2d 455 at 459 (1996).

[18] Re: Sierra Pacific Power Company for approval of its transition plan.

litigation costs, which occur over a seven to eight month period from the filing of its ROE application to a decision.

The automatic trigger mechanism being proposed by Sierra would adjust the authorized ROE when 10-year Treasury note rates change by more than 150 basis points, based on the average yield of U.S. Treasury 10-year notes from September 1 of one year to August 31 of the following year. If a ROE change were triggered, the cost of debt and preferred stock would also be recalculated to reflect the actual embedded costs and the authorized weights of these components would be adjusted if they changed by more than 5%. An advice letter filing would make revenue requirement changes and implement the appropriate electric rate changes. Sierra also recommends that this automatic trigger mechanism continue in effect for a three-year test period to determine the viability of the mechanism.

ORA agrees with Sierra that ROE regulation should be more objective and less expensive. However, ORA opposes approval of Sierra's automatic trigger mechanism unless specific changes are made to improve the mechanism and to make it consistent with similar mechanisms approved for Southern California Edison Company (Edison) and SDG&E. ORA recommends that the benchmark be based on AA utility bonds and triggered upon a change of at least 100 basis points instead of U.S. Treasury 10-year notes and a 150 basis points trigger. It also recommends that the ROE be updated by 50% of the change in interest rates when the trigger is exceeded. ORA recommends that the interest rate measurement period be April to September of the same year instead of September 1 of one year to August 31 of the following year. In regards to resetting the ROE when economic conditions change dramatically, ORA recommends the establishment of a 260 basis point offramp. Finally, ORA recommends that a formal cost-of-capital application be required every five years, regardless of whether or not an automatic trigger mechanism offramp is reached. Sierra agrees that the trigger mechanism modifications proposed by ORA are fair and reasonable, and should be adopted.

PG&E also recommend approval of an automatic adjustment mechanism incorporating ORA's proposed changes. PG&E believes that AA utility bonds are a more stable reference point than Sierra's proposed 10 year treasuries to adjust energy utilities' cost of common equity, and that ORA's proposed 100 basis point trigger is more sensitive than Sierra's proposed 150 basis point trigger.

Aglet initially opposed a trigger mechanism because Sierra did not explain why it is reasonable or how it would protect ratepayers against unreasonable rates of return. However, based on its comparison of costs and risks, Aglet determined that the impact of annual ROE litigation cost exceeds $2.00 per customer and may run as high as $5.00 per customer. Aglet also found that the annual ROE litigation cost could reduce Sierra's actual California earnings by 30 basis points.

Aglet now concludes that litigation cost savings justify adoption of a trigger mechanism for Sierra but does not agree with Sierra or ORA regarding all of the details of the trigger mechanism. For example, Aglet recommends a four-year duration of the mechanism before a ROE application is required, the use of 10 year Treasuries, and a 200 basis points offramp. Aglet also recommends that the interest rate measurement be based on the DRI forecast of 10-year Treasury rates relative to the October forecast from the previous year. Aglet further recommends a deadband of 15 basis points from a change in the DRI forecast of 10-year Treasury rates or 10 basis points from a change in the ROE.

Similar to Aglet, API opposed the automatic trigger mechanism being proposed by Sierra and reconsidered its opposition because of the evidence placed into the record during the evidentiary hearing. API included in its opening brief the results of an analysis it conducted subsequent to the evidentiary hearing to determine whether an automatic trigger mechanism would be beneficial for Sierra's ratepayers. API addressed the cost-effectiveness if litigation costs were to be split equally between shareholders and ratepayers and the impact of changes that would have been made to Sierra's allowed ROE if ORA's recommended automatic trigger mechanism had been in place since 1991. Based on this analysis, API concluded that an automatic trigger mechanism is not appropriate for Sierra.

Although API used data in the evidentiary record to conduct its analysis, the data pertained to PG&E's allowed return on equity, and did not reflect any impact from Sierra's allowed ROEs predominately authorized via settlements. However, we note that there is no difference upon comparing Sierra's 11.60% ROE, which has been authorized since 1996 to API's 11.60% calculation of ROE under ORA's automatic trigger mechanism for each year since 1996. Because the analysis conducted by API was not subject to examination during the evidentiary hearings we have no basis to accept API's results as being reliable and thus accord it little weight.

Except for API, the parties seek to streamline the regulatory process by replacing the annual cost of capital proceeding with an automatic trigger mechanism through annual advice letter filings. Such trigger mechanisms are already in place for the major California energy utilities including SDG&E and Edison. Sierra, with approximately 44,000 California electric customers or eight percent of its total electric operations, should be afforded the same opportunity as the major energy utilities to benefit from a streamlined regulatory process. We find that the adopted trigger mechanism should be a fair balance between shareholders' interests and ratepayers' interest and should also provide Sierra the opportunity to earn a fair rate of return as set forth in the 1923 Bluefield decision.[19]

We concur with the majority of parties that it is fair and reasonable to adopt an automatic trigger mechanism for Sierra that would replace the subjectivity of the current methods used to establish a fair ROE with objective financial data while streamlining the annual ROE process. The changes proposed by ORA establish a fair balance between shareholders' and ratepayers' interest and are intended to make Sierra's automatic trigger mechanisms consistent with the automatic trigger mechanisms in existence for the major California energy utilities. The adoption of a cost of capital mechanism does not preclude the Commission from requiring Sierra to file a cost of capital application at anytime.

Several of Aglet's proposed changes would conflict with the automatic trigger mechanism of the major California energy utilities in existence or currently being considered in other proceedings. We will adopt Sierra's automatic trigger mechanism as modified by ORA and set forth in Chapter 3 of Exhibit 9. We further preclude Sierra from adjusting its capital structure as part of the automatic trigger mechanism. Adjustments to its capital structure should be made by application.

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[19] Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923).

Aglet raised the issue of whether an adjustment to the automatic adjustment mechanism should be established in test year 2002 to reflect the unbundling of Sierra's distribution function. Consistent with D.99-06-057, Sierra should file a cost of capital application limited in scope to address the limited issue of whether a one-time ROE adjustment related to a distribution risk discount or unbundling adjustment should be included in its automatic trigger mechanism.

Comments on Proposed Decision

The principal hearing officer's proposed decision on this matter was filed and served pursuant to Public Utilities Code Section 311(d) and Rule 77.1 of the Commission's Rules.

Comments to the proposed decision were timely filed by Sierra, Aglet, and ORA. Reply comments by Aglet and API were timely filed and received. The comments and reply comments filed by the parties to this proceeding have been carefully reviewed and considered. To the extent that such comments required discussion or changes to the proposed decision, the discussion or changes have been incorporated into the body of this order.

Findings of Fact

1. Sierra is a public utility electric and gas corporation subject to the jurisdiction of this Commission.

2. Sierra seeks authority to change its authorized ROE for its electric distribution system in 2001.

3. Sierra provided notice of its cost of capital application to its customers, and to the cities, counties, and the state affected by its application.

4. The legal standard for setting the fair rate of return has been established by the United States Supreme Court in the Bluefield and Hope cases.

5. There is no dispute over the reasonableness of Sierra's proposed capital structure.

6. There is no dispute over the reasonableness of Sierra's proposed costs of long-term debt and preferred stock.

7. The ROE recommended by individual parties ranged from 10.50% to 12.00%.

8. CAPM, DCF, and MRP are the quantitative financial models commonly used as a starting point to estimate a fair ROE.

9. Although the quantitative financial models are objective, the results are dependent on subjective inputs.

10. The individual parties' use of quantitative financial models resulted in a broad ROE range from 9.30% to 12.90%.

11. There is a 28 basis points reduction in the 2001 DRI interest rate forecast for AA utility bonds between April 2000 and October 2000.

12. It is the application of informed judgment, not the precision of quantitative financial models, which is the key to selecting a specific ROE.

13. Sierra's rates have been frozen since 1996.

14. There is no dispute over Sierra's 2001 $91,620,000 total California ratebase set forth in late filed Exhibit 22, of which $16,245,000 is applicable to generation, $13,904 to transmission, and $61,371 to distribution, as detailed in Sierra's PBR application.

15. D.96-12-084 required Sierra to file cost of capital and PBR applications for implementation January 1, 2001.

16. D.97-12-093 modified Sierra's rate freeze to conform with Assembly Bill 1890.

17. Sierra seeks authority to replace its annual cost of capital filing with an automatic trigger mechanism.

18. Annual costs of capital trigger mechanisms are in place for the major California energy utilities, including SDG&E and Southern California Gas Company.

Conclusions of Law

1. Sierra's proposed capital structure for test year 2001 should be adopted.

2. Sierra's 2001 proposed long-term debt and preferred stock costs are reasonable and should be adopted.

3. A 10.80% ROE for test year 2001 is just and reasonable for Sierra.

4. The 10.80% ROE should be applied to Sierra's authorized rate base for California.

5. Sierra should adjust its rate components associated with the decreased revenue requirement resulting from the ROE being adopted by this order through an advice letter filing.

6. Sierra's annual cost of capital filing requirement should be replaced with an automatic trigger mechanism.

7. A one-time ROE adjustment related to a distribution risk discount or unbundling adjustment should be addressed in Sierra's first automatic trigger mechanism filing.

8. The application should be granted to the extent provided for in the following order.

O R D E R

IT IS ORDERED that:

1. Sierra Pacific Power Company's (Sierra) cost of capital for 2001 is as follows:

Component	**Capital Ratio**	**Cost Factor**	**Weighted Cost**
Long Term Debt	47.56%	7.47%	3.55%
Preferred Stock	7.67	8.10	0.62
Common Equity	44.77	10.80	4.84
Total:	100.00**%**		9.01%

2. Sierra shall adjust its authorized revenue requirement to reflect the Return on Equity (ROE) being adopted in this decision and to adjust its rate components associated with the change in revenue requirement by an advice letter filing five days after the effective date of this order. Sierra shall use its 2001 distribution rate base set forth in its Cost of Service and Performance-Base Ratemaking (PBR) Application (A.) 00-07-001. Sierra shall true-up its distribution rate base to that rate base subsequently adopted in its Cost of Service and PBR application. The advise letter shall become effective January 1, 2001, subject to Energy Division's finding that the advice letter is in compliance with this order.

3. An automatic trigger mechanism for Sierra's ROE shall be adopted and replace the annual cost of capital filing as set forth in the body of this decision. Capital structure adjustments shall not be made through the automatic trigger mechanism. Applications required at the five-year interval and upon the triggering of an offramp shall be used to address any change in Sierra's capital structure. The automatic trigger mechanisms are summarized as follows:

- A benchmark shall be established based on AA utility bonds and triggered upon a change of at least 100 basis points.
- The ROE shall be updated by 50% of the change in interest rates when the trigger is exceeded.
- The interest rate measurement period shall be April to September of the same year.
- An offramp of 260 basis points shall be established.
- A formal cost-of-capital application shall be filed every five years from 1999, regardless of whether or not an automatic trigger mechanism offramp is reached prior to that time.
- Sierra shall file a yearly advice letter detailing the results of its trigger mechanism by November 1st of each year.

4. Sierra shall file a 2002 cost of capital application in May of 2001 limited in scope to address any impact of risk associated with its unbundled distribution services.

5. A.00-05-018 is closed.

This order is effective today.

Dated December 22, 2000, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
CARL W. WOOD
Commissioners

APPENDIX A

TABLE OF ACRONYMS AND ABBREVIATIONS

A.	Application
Aglet	Aglet Consumer Alliance
API	Advocates for Public Interest
ALJ	Administrative Law Judge
CAPM	Capital Asset Pricing Model
D.	Decision
DCF	Discounted Cash Flow
Edison	Southern California Edison Company
ORA	Office of Ratepayer Advocates
PBR	Performance Based Rate Making
PG&E	Pacific Gas & Electric Company
PHC	Prehearing Conference
ROE	Return on Equity
MRP	Market Risk Premium
Rules	Commission's Rules of Practice and Procedure
SDG&E	San Diego Gas and Electric Company
Sierra	Sierra Pacific Power Company

(END OF APPENDIX A)