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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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- KRISTIN K. MAYES
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- GARY PIERCE
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- SANDRA D. KENNEDY
COMMISSIONER
- PAUL NEWMAN
COMMISSIONER
- BOB STUMP
COMMISSIONER

Docket No. WS-02676A-09-0257

IN THE MATTER OF THE APPLICATION OF
RIO RICO UTILITIES, INC., AN ARIZONA
CORPORATION, FOR A DETERMINATION
OF THE FAIR VALUE OF ITS UTILITY
PLANTS AND PROPERTY AND FOR
INCREASES IN ITS WATER AND
WASTEWATER RATES AND CHARGES
FOR UTILITY SERVICE BASED THEREON.

RESIDENTIAL UTILITY CONSUMER OFFICE'S ("RUCO")
EXCEPTION

The Residential Utility Consumer Office ("RUCO") hereby makes the following
Exception to the Recommended Opinion and Order ("ROO") on Rio Rico Utilities ("Rio Rico" or
"Company") application for a rate increase.

RUCO's only exception to the ROO concerns the cost of capital. The ROO adopted the
Company's actual capital structure of 100 percent equity and adjusted for lower risk through
the use of the Hamada method. The ROO adjusts the return on equity to 9.2 percent. Since
there is no debt, the 9.2 percent cost of equity results in a 9.2 percent cost of capital. A 9.2

1 percent cost of capital is higher than the awards the Commission has authorized in recent
2 cases.¹

3 RUCO applied a 60/40 hypothetical capital structure and is recommending a return on
4 equity of 9.00 percent and a weighted average cost of capital of 7.90%. RUCO's
5 recommendation is fair and equitable to both the ratepayer and the Company and will result in
6 lower rates.

7 The use of a hypothetical capital structure is preferable over the Hamada method where
8 the Company has such a lopsided capital structure. This very point was recognized by the
9 Commission in this Company's last rate case. In Decision No. 67279, the Commission noted:

10
11 However, the Company's capital structure is comprised entirely
12 of equity, at a time when the cost of debt is low. As a result, ratepayers
13 are penalized by the Company's choice of a capital structure consisting
14 entirely of higher cost equity. Although we are not using a hypothetical
15 capital structure in this case, we believe that recognition of this
16 imbalance should be reflected in the authorized rates for return for the
17 wastewater division, which experienced an operating loss during the
18 test year. Decision No. 67279 at 13.

19 The Company has chosen to not change its capital structure since its last case despite the
20 Commission's admonishment as to its imprudence and its ability to acquire low cost debt
21 through its parent, Algonquin. The best way to recognize the imbalance is to utilize the
22 hypothetical capital structure as the Commission did in the recent Gold Canyon case (another
23 Algonquin utility). In *Gold Canyon*, the Commission agreed with RUCO that Gold Canyon
24 "should not be rewarded for its imprudent and unbalanced capital structure." (Decision No.
70624 at 14. (RUCO has attached a proposed amendment).

¹ Arizona-American 7.3% (Decision No. 71410), Arizona Water 7.87% (Decision No. 71845), Chaparral City 7.52% (Decision. No. 71308).

1 RESPECTFULLY SUBMITTED this 9th day of December, 2010.

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5 Daniel W. Pozefsky
Chief Counsel

6 AN ORIGINAL AND THIRTEEN COPIES
7 of the foregoing filed this 9th day of
8 December, 2010 with:

9 Docket Control
10 Arizona Corporation Commission
11 1200 West Washington
12 Phoenix, Arizona 85007

13 COPIES of the foregoing hand delivered/
14 mailed this 9th day of December, 2010 to:

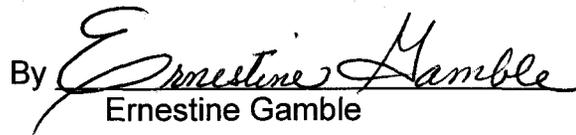
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RIO RICO UTILITIES, INC.
WS-02676A-09-0257

RUCO's Amendment No. 1
(Cost of Capital)

Page 33 Line 18 – Page 34, Line 22

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INSERT We agree with RUCO's hypothetical capital structure of 40 percent debt and 60 percent equity. The proposed capital structure adopted by the Commission will bring the Company's capital structure and weighted cost of capital in line with the industry average and it will result in lower rates for customers of the system. We therefore adopt a hypothetical capital structure of 40 percent debt and 60 percent equity.

We believe that RUCO's recommendation for a 9.00 percent cost of equity capital is appropriate, and will adopt it in this case. RUCO's expert relied on a DCF model and a CAPM analysis for calculating his cost of equity. We believe the adoption of RUCO's recommendations results in just and reasonable rates for Rio Rico based on the record in this proceeding. We therefore adopt a cost of equity of 9.00 percent, which also results in an overall weighted cost of capital of 7.90 percent.

Make all conforming changes.