

E-299,132/SA-93-498

ORDER DETERMINING COMPENSATION AND DENYING MOTION TO DISMISS

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Joel Jacobs  
Tom Burton  
Marshall Johnson  
Dee Knaak  
Don Storm

Chair  
Commissioner  
Commissioner  
Commissioner  
Commissioner

In the Matter of the Application by the City of  
Rochester for an Adjustment of its Service  
Area Boundaries With People's Cooperative  
Power Association, Inc.

ISSUE DATE: November 30, 1995

DOCKET NO. E-299,132/SA-93-498

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AND DENYING MOTION TO DISMISS

**PROCEDURAL HISTORY**

**I. Initial Proceedings Before the Commission**

On May 28, 1993 the City of Rochester filed a petition under Minn. Stat. § 216B.44 stating it intended to expand its assigned service area to include specified areas within its city limits annexed between 1991 and 1993. These areas lie within the assigned service area of People's Cooperative Power Association. The petition asked the Commission to determine appropriate compensation to People's for the loss of service rights to these areas.

The Commission deferred action on the petition at the request of the parties, who reported they were engaged in settlement negotiations. When negotiations broke down, the Commission again took up the matter and referred it to the Office of Administrative Hearings for contested case proceedings.<sup>1</sup> That office assigned Administrative Law Judge (ALJ) Phyllis A. Reha to hear the case.

On May 25, 1994 the Commission issued an Amended Notice and Order for Hearing at the request of the parties. That Order asked the ALJ to determine compensation for additional areas the City had annexed after its original filing.

**II. Contested Case Proceedings**

**A. The Parties**

The parties to this case are the City of Rochester (the City), People's Cooperative Power Association (People's or the co-op), and the Minnesota Department of Public Service (the Department). The Department intervened as of right under Minn. Stat. § 216A.07, subd. 3.

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<sup>1</sup>Notice and Order for Hearing, July 22, 1993.

All parties were represented by counsel.

The City was represented by Joseph F. Chase and Julia E. Utz, O'Brien, Ehrick, Wold, Deaner & Maus, Suite 611, 206 South Broadway, Post Office Box 968, Rochester, Minnesota 55903.

People's was represented by Kenneth R. Moen, Dunlap & Seeger, P.A., Suite 505, 206 South Broadway, Post Office Box 549, Rochester, Minnesota 55903.

The Department was represented by Brent Vanderlinden, Assistant Attorney General, 1200 NCL Tower, 445 Minnesota Street, St. Paul, Minnesota 55101-2130.

The Commission was not a party, but did appear by W. Stuart Mitchell, Rate Analyst, Minnesota Public Utilities Commission, Suite 350 Metro Square Building, 121 Seventh Place East, St. Paul, Minnesota 55101-2147.

### **B. Motion to Dismiss; Evidentiary Hearings**

On November 23, 1994 People's filed a motion to dismiss this case on constitutional grounds. People's claimed that allowing the City to exercise its statutory right to acquire service rights in this case would so interfere with the operation of the federal Rural Electrification Act that application of the state statute was preempted under the supremacy clause of the United States Constitution.

The Administrative Law Judge took the motion under advisement and proceeded with evidentiary hearings. Evidentiary hearings were held in St. Paul on December 7, 8, 9, 12, 13, 14, and 15, 1994.

The record on the motion closed March 6, 1995; the record on the remainder of the case closed March 14, 1995

On May 31, 1995 the Administrative Law Judge served the Commission and all parties with her Findings of Fact, Conclusions and Recommended Order (Recommended Order) in the main case and her Recommended Order on Motion to Dismiss.

### **III. Subsequent Proceedings Before the Commission**

On June 20 and 21, People's and the City filed exceptions to the Findings of Fact, Conclusions and Recommended Order of the Administrative Law Judge. On June 29 and 30, People's, the City, and the Department filed replies to exceptions.

On September 14, 1995 the Commission heard oral argument from all parties.

Having reviewed the entire record and having heard the arguments of the parties, the Commission makes the following findings, conclusions, and Order.

## FINDINGS AND CONCLUSIONS

### **IV. Statutory Background**

#### **A. Assigned Service Areas**

In 1974 the Minnesota Legislature determined that the orderly development of economical statewide electric service required granting electric utilities exclusive service rights within designated service areas:

It is hereby declared to be in the public interest that, in order to encourage the development of coordinated statewide electric service at retail, to eliminate or avoid unnecessary duplication of electric utility facilities, and to promote economical, efficient, and adequate electric service to the public, the state of Minnesota shall be divided into geographic service areas within which a specified electric utility shall provide electric service to customers on an exclusive basis.

Minn. Stat. § 216B.37.

The Commission was required to establish assigned service areas for all electric utilities by April 12, 1975 and to prepare official service area maps showing the boundaries of the service areas established. The Commission did so.

#### **B. Compensation for Municipal Acquisitions**

The Legislature recognized that service areas would require adjustment over time, especially as cities and towns with municipal utilities grew. The Legislature therefore established a procedure, codified at Minn. Stat. § 216B.44, to allow municipal utilities to acquire portions of other utilities' service areas within their city limits. Under the statute, municipal utilities may serve such areas at will if they are not receiving service from the assigned utility. If they are receiving service from the assigned utility, the municipal utility must first pay compensation.

If the two utilities are unable to agree on compensation, either of them may ask the Commission to determine compensation. In this case, the utilities were unable to agree and asked the Commission to decide the issue.

While compensation is being determined, the assigned utility continues to serve the area. The Commission may allow the municipal utility to serve new customers in the area if it finds, after notice and hearing, that allowing the assigned utility to serve them would not be in the public interest. In this case the Commission did grant the City the right to serve new customers in specified areas while compensation was being determined.

### **V. The Administrative Law Judge's Recommendations**

#### **A. Total Compensation -- Two Alternatives**

In setting compensation the Commission is to consider “the original cost of the property, less depreciation, loss of revenue to the utility formerly serving the area, expenses resulting from integration of facilities, and other appropriate factors.” Minn. Stat. § 216B.44. Considering these factors, the Administrative Law Judge formulated two alternative compensation awards. One was a traditional lump sum for all losses, present and future. The other was a lump sum for present losses and a mill rate for future losses.

The Administrative Law Judge set the traditional lump award at \$761,086, which breaks down into its statutory components as follows:

- Original cost of property less depreciation -- \$70,607
- Loss of Revenue -- \$540,667
- Integration Expenses -- \$21,171
- Other appropriate factors -- \$129,306 (\$25,655 for residual power supply demand charges; \$103,651 for People’s’ share of the revenue loss of its wholesale supplier).

The alternative award combined a lump sum for the loss of current customers in the annexed areas and a mill rate for future customers. The lump sum came out to \$175,086; the mill rate to 12.2 per kilowatt hour of sales to future customers.<sup>2</sup>

The lump sum portion of the alternative award is the original lump sum, set forth above, minus all amounts attributable to the loss of future customers. The mill rate portion is the remainder (all amounts attributable to the loss of future customers), prorated per projected kilowatt hour of sales to future customers. Should the ALJ’s future sales projections turn out to be 100% accurate, the single lump sum award and the alternative award would turn out to be the same.

## **B. Applying the Statutory Factors**

### **1. Original Cost of Property, Less Depreciation and Integration Expenses**

The parties agreed that the facilities People’s would transfer to the City had an original cost of \$132,915, depreciation reserves of \$62,308, and a net value of \$70,607. These figures were accurate as of June 30, 1994 and would require updating to the date of transfer. Similarly, the parties agreed that the cost to People’s of reconfiguring its system to compensate for the lost facilities and lost customers would be \$21,171.

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<sup>2</sup>All parties have since agreed the mill rate should be adjusted to 11.0 to correct a mathematical oversight. The Commission assumes the ALJ would concur, since her recommended Order states any conflict between dollar figures and concepts should be resolved in favor of concepts. Recommended Order, Conclusion No. 19.

## **2. Lost Revenues**

To determine lost revenues the Administrative Law Judge used the “direct net revenue loss” method. In brief, the method has four steps: (1) determine the annual gross revenue loss from losing service rights to the area; (2) determine the incremental reduction in annual operating expenses from no longer serving the area; (3) subtract the second figure from the first to get incremental annual revenue loss; (4) calculate annual net revenue losses over the compensation period and reduce the total to present worth.

The direct net revenue loss method has not been used in the past by ALJ’s or the Commission, but it has been used by parties in settlements. Its use in this case was supported by the City and the co-op, and was unopposed by the Department.

Under either method, a crucial part of determining revenue loss is deciding how long to measure it and compensate for it. The Administrative Law Judge found that ten years was the most reasonable time period. She recommended that the ten years begin on the date service rights were formally transferred to the City.

## **3. “Other Appropriate Factors”**

People’s wholesale supplier, Dairyland Power Cooperative, charges each member co-op a monthly demand charge based on the amount and timing of the co-op’s purchases over the past three years. The Administrative Law Judge included in the compensation award \$25,655 for the demand charges People’s would continue to pay for the past usage of transferred customers. She also included People’s share of the revenue loss Dairyland would sustain due to the transfer of these customers, assuming it would be passed on to People’s in the form of higher rates.

## **C. Constitutional and Statutory Interpretation Issues**

The Administrative Law Judge rejected People’s federal preemption claim and recommended denying the motion to dismiss. She also rejected the City’s argument, denied in previous cases and raised here to preserve appeal rights, that no compensation was required for “bare ground” annexations. (Bare ground annexations are those involving areas that do not contain customers or utility facilities.)

## **VI. Issues in Dispute**

### **A. People’s Exceptions**

People’s filed exceptions to the Administrative Law Judge’s recommendations on three issues:

- Length of Compensation Period

The ALJ recommended that compensation for lost revenues end after ten years. People’s claimed compensation should run forever, because co-op revenues would always be lower than

they would have been if the co-op were still serving the transferred areas.

- When Compensation Period Begins

The ALJ recommended that the 10-year compensation period begin on the date service rights were formally transferred from People's to the City. People's argued that, if compensation were limited to a finite period, that period should begin on the date service was first extended to an actual customer in platted areas. In unplatted areas it should begin for each individual customer on the date service was extended to that customer.

- Choosing Between Alternative Compensation Awards

The ALJ did not state who should decide which of the two compensation awards should be granted. People's said it should have the right to choose between the two. This exception was later withdrawn, when all parties agreed to support the award combining a lump sum and a mill rate.

## **B. The City's Exceptions**

The City filed exceptions to the Administrative Law Judge's recommendations on five issues:

- Compensation for "Bare Ground" Annexations

The City took exception to the ALJ's rejection of its claim that no compensation was due for "bare ground" annexations, annexations of areas in which the displaced utility has no customers or facilities. The Commission has rejected this argument in previous decisions, two of which have been appealed and upheld. The City raised the argument to preserve its appeal rights, should the issue reach the Minnesota Supreme Court.

- Calculation of the Mill Rate

The City challenged the ALJ's calculation of the mill rate as too high, both arithmetically and because it reflected the alleged substantive errors set forth in the City's other Exceptions. As noted above, the ALJ's mill rate has since been adjusted by agreement of the parties to 11.0.

- When Compensation Period Begins

The ALJ recommended that the 10-year compensation period begin on the date service rights were formally transferred from People's to the City. The City agreed, except as to areas to which the City had been granted interim service rights. For these areas, the City argued, the compensation period should begin on the date of the interim service Order.

- Compensation for Increased Wholesale Rates

The City challenged the ALJ's determination that People's should be compensated for expected increases in wholesale rates, due to its supplier's loss of the customers acquired by the City.

- Credit for Subsequent Depreciation of Acquired Property

The ALJ recommended adjusting the compensation award to reflect any subsequent investments People's made in or to facilities ultimately transferred to the City. The City asked that similar adjustments be made for subsequent depreciation. No one challenged this request.

## **VII. Commission Action**

### **A. Summary of Commission Action**

The Commission will order compensation in the form of a lump sum for service rights to existing customers and a mill rate for service rights to future customers. The Commission accepts and adopts the findings, conclusions, and recommendations of the Administrative Law Judge, with the following exceptions:

- The mill rate, set by the ALJ at 12.2, will be adjusted to 11.0 to reflect a mathematical oversight;
- The lump sum calculated by the ALJ will be adjusted to reflect all changes in capital investment and depreciation until the date permanent service rights are transferred to the City.

Unless specifically rejected or modified herein, all her other findings, conclusions, and recommendations are accepted and adopted for the reasons set forth by the Administrative Law Judge.

The Commission's decisions on contested and novel issues are explained below.

## **B. Length of Compensation Period**

The Commission adopts a ten-year compensation period for the reasons set forth by the Administrative Law Judge.

## **C. When Compensation Period Begins**

### **1. People's Position**

People's argued that, if compensation is limited to a finite period, it should begin in platted areas on the date service is first extended to the area. In unplatted areas, it should be calculated on an individual customer basis and should begin on the date service was first extended to the customer.

This claim rests on the same assumptions as the claim to perpetual compensation and is rejected for the same reasons. The co-op is expected to adjust to new service realities and to mitigate its damages for loss of these service rights as quickly and efficiently as possible. A single ten year compensation period provides reasonable opportunity to do this.

The Commission also finds that establishing different compensation periods for different platted areas, and for different customers within unplatted areas, would not be administratively feasible. It would be burdensome in the short run and intolerable in the long run. Some compensation periods could begin twenty, or even fifty, years after the date of this Order, when changes in circumstances could have eliminated any justification for compensation.

### **2. The City's Position**

The Commission also rejects the City's proposal that the compensation period begin with the interim service Order for those areas to which it has been granted interim service rights. Interim service does not relieve the assigned utility of its obligation to serve. It merely allows the acquiring utility to serve new customers, largely to avoid compounding the duplication and integration of facilities issues that arise in municipal acquisition cases.

People's was and is ultimately responsible for serving these areas until compensation is paid and service rights are formally transferred. The date of formal transfer is the appropriate date for compensation to begin.

## **D. Lump Sum/Mill Rate Compensation Award**

The Commission agrees with the Administrative Law Judge and the parties that in this case the compensation award combining a lump sum for present customers and a mill rate for future customers is the most reasonable choice.

Accounting for future revenue losses is one of the most difficult issues in setting compensation. Although the potential for error in estimating future growth is significant, there is no practical alternative to relying on estimates of future growth in setting compensation.

Compensation for future customers must be determined before those customers appear, to avoid uncertainty and interminable compensation proceedings.

A mill rate is an effective way to tie compensation for future growth to actual growth, without sacrificing finality and certainty. It protects against egregious differences between compensation and actual losses, should future growth turn out to be dramatically higher or lower than expected. For all these reasons, the Commission will adopt the combination lump sum/mill rate award calculated by the ALJ.

#### **E. “Bare Ground” Annexations**

To preserve its appeal rights, the City raised a claim the Commission has consistently rejected: that no compensation is due for “bare ground” annexations, annexations of areas in which the displaced utility has no customers or facilities. The Commission has rejected this argument for reasons set forth in detail in previous Orders, such as its July 11, 1990 Order Determining Compensation,<sup>3</sup> incorporated herein by reference. The Court of Appeals has twice upheld the Commission’s rejection of this argument.<sup>4</sup> The City stated it raised the claim here to preserve its rights in the event of Supreme Court review.

The Commission continues to believe that disallowing compensation for bare ground annexations would be inequitable, would violate Minn. Stat. § 216B.44, and would undermine the long term planning by utilities that the service area statutes were enacted to ensure.

In its Exceptions to the Recommendations of the Administrative Law Judge, the City argued for the first time that this case was different from other bare ground cases, because here People’s did not have in place “adequate backbone facilities and sufficient capacity to serve the future customers and load projected for the acquisition area over the ten year compensation period.” Exceptions, p. 7.

Since this argument was introduced at the Exception stage, the parties and the Administrative Law Judge did not develop the record on the exact status and capacity of People’s’ facilities vis-a-vis the exact needs of the areas at issue over the ten year compensation period. Neither issue, however, is relevant.

“Having facilities in place capable of serving the area,” and similar phrases used in bare ground cases, are short hand methods of saying that utilities that intend to discharge their duty

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<sup>3</sup>In the Matter of the Complaint Regarding the Annexation of a Portion of the Service Territory of People’s Cooperative Power Association by the City of Rochester (North Park Additions), Docket No. E-132, 299/SA-88-270.

<sup>4</sup>In re Annexation of a Portion of the Service Territory of People’s Cooperative Power Association, 470 N.W.2d 525 (Minn.App.1991), *pet. for rev. denied* (Minn. July 24, 1991); In the Matter of the Complaint by Kandiyohi Cooperative Electric Power Association, 455 N.W.2d 102 (Minn.App. 1990).

to serve an area and have taken reasonable steps consistent with that duty are entitled to compensation. They do not have to show that they have in place the facilities and capacity to serve the area for the entire compensation period. As the Court of Appeals said in the Kandiyohi case, quoting the Commission:

The relevant question is whether the displaced utility has facilities in place capable of serving the area. Answering this question does not require an examination of either utility's long-term capacity needs or of the long-term service needs of the area in question. The only issue is whether the utility the municipality seeks to displace can provide service to the area in the near term while compensation issues are being resolved. . . .

In the Matter of the Complaint by Kandiyohi Cooperative Electric Power Association, 455 N.W.2d 102, 106 (Minn.App. 1990).

People's clearly had and has facilities in place to fulfill its service obligation to the areas at issue while compensation issues are being resolved. It therefore meets the Commission's definition of "having facilities in place capable of serving the area."

The Commission rejects the argument that bare ground acquisitions are non-compensable and rejects the argument that People's facilities and capacity in this case fall short of that necessary to entitle it to compensation.

#### **F. Compensation for Increased Wholesale Rates**

The Administrative Law Judge, following Commission precedent in the North Park case, recommended compensating People's for increases in wholesale rates due to its wholesale supplier's loss of load from the transferred areas. The City argued that, properly calculated, these losses are too trivial to be included in compensation. The City also challenged the ALJ's calculation of the losses.

The Commission affirms the ALJ's calculation of these losses and emphasizes that, to the extent that they are measurable, they are compensable. To the extent that they are trivial, they will have no appreciable effect on compensation and should not be a matter of concern.

#### **G. Credit for Subsequent Depreciation of Acquired Property**

The ALJ recommended adjusting the compensation award to reflect any subsequent investments People's made in or to facilities ultimately transferred to the City. The City asked that similar adjustments be made for subsequent depreciation. No one challenged this request.

The Commission assumes the ALJ failed to mention crediting the City with accrued depreciation through inadvertence. Compensation will reflect all changes in capital investment and depreciation until the date the property changes hands.

### **ORDER**

1. The Commission finds that appropriate compensation to People's Cooperative Power Association for the City of Rochester's acquisition of service rights to the areas at issue is a lump sum of \$175,086, adjusted to reflect all changes in capital investment and depreciation to the date of transfer, and a mill rate of 11.0 per kilowatt hour of usage by future customers.
2. The mill rate shall be payable for ten years from the date of transfer.
3. People's Cooperative Power Association's motion to dismiss is denied.
4. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar  
Executive Secretary

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