

NO. A05-2550

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State of Minnesota  
**In Court of Appeals**

In the Matter of the Application of the Grand Rapids Public  
Utilities Commission to Extend Its Assigned Service Area Into  
the Area Presently Assigned to Lake Country Power

Grand Rapids Public Utilities Commission,

*Relator,*

vs.

Minnesota Public Utilities Commission,  
Lake Country Power,

*Respondents.*

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**INITIAL BRIEF AND ADDENDUM OF  
RELATOR GRAND RAPIDS PUBLIC UTILITIES COMMISSION**

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## STATEMENT OF ISSUES

- I. Was the Commission's decision to impose compensation without any check on the reasonableness of the award unconstitutional, arbitrary, or capricious?

The Commission adopted LCP's approach to compensation.

*See: Flanagan v. Lindberg*, 404 N.W.2d 799 (Minn. 1987)

*Manufactured Hous. Institute v. Petterson*, 347 N.W.2d 238 (Minn. 1984)

- II. Did the Commission err in applying the statutory factors of section 216B.44 by failing to recognize the full avoidable wholesale power costs?

The Commission adopted LCP's approach to compensation, with a minor modification.

*See: Minn. Stat. § 216B.44*

- III. Did the Commission err in applying the statutory factors of section 216B.44 by not considering the true costs of service that LCP will avoid?

The Commission adopted LCP's approach to compensation, with a minor modification.

*See: Minn. Stat. § 216B.44*

*In re Annexation of Service Territory of People's Cooperative Power Ass'n*, 470 N.W.2d 525 (Minn. App. 1991)

## STATEMENT OF THE CASE

The City of Grand Rapids, under Minn. Stat. § 412.321, established the Grand Rapids Public Utilities Commission (“GRPUC”), which furnishes electric service to the citizens of Grand Rapids. The City annexed approximately 56.1 acres known as the Stoeke-Maxwell Addition, as well as approximately 362.1 acres composed of several additions referred to as Area 2 (collectively the “Annexed Area”). The Annexed Areas fell within the assigned electric service territory of Lake Country Power (“LCP”) under section 216B.40. The Annexed Area included 134 existing residential customers and two small commercial customers.

GRPUC petitioned the Minnesota Public Utilities Commission (“MPUC”) to acquire the Annexed Areas to provide exclusive electric service under section 216B.44. That section allows municipal utilities to acquire the electric service territory assigned to another electric utility within the municipal’s city limits, upon the payment of “appropriate” compensation. *Id.* Section 216B.44 lists as one of four factors to determine appropriate compensation the “loss of revenue” to the displaced utility.

The Administrative Law Judge determined that LCP’s proposal was unreasonable, that GRPUC presented the more accurate position, and that no compensation should be paid for future customers. This conclusion was based upon credibility findings in favor of GRPUC’s witnesses, as well as findings that the Annexed Areas were unlikely to have any new customers within the ten year compensation period. The ALJ also credited evidence and testimony from the Department of

Commerce that past Commission orders and settlements provided a “general rule” of compensation of 7-8 mills<sup>1</sup> per kilowatt hour of energy consumed.

At the contested case hearing, GRPUC recommended loss-of-revenue for existing customers in the amount of 16.5 mills/kWh (present value of \$204,402). LCP, by contrast, recommended loss of revenue for existing customers in the amount of 35.4 mills/kWh, or present value of \$438,661. LCP’s expert testified that even its proposed award – nearly five times higher than the seven-to-eight mill range established in prior orders and settlements – was insufficient. The ALJ recommended an award of either 15.5 mills/kWh for existing customers or an alternative approach of two times gross revenues, an MPUC-approved “check” on the reasonableness of the award.

In its September 29, 2005 Order, the MPUC reversed the ALJ report and recommendation. The MPUC adopted LCP’s number of 35 mills and subtracted five mills, contrary to LCP’s own adjusted numbers for wholesale power costs. The Order rejected the four reasonableness test considered by the ALJ, including a multiplier of gross revenues.

The MPUC also held that loss-of-revenue for future customers was required, even in the area without support for any customers. The MPUC did not consider the new evidence of the great costs to truly serve an area, and rejected GRPUC’s analysis of the costs that LCP would avoid by not serving the Annexed Areas

GRPUC filed a petition for rehearing and reconsideration. The MPUC did not move to reconsider or conduct a rehearing on the petition, and in an order dated December 2, 2005, the MPUC denied the petition. On December 29, 2005, GRPUC filed a petition for writ of certiorari.

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<sup>1</sup> A mill is the equivalent of one tenth of one cent (\$.001).

## STATEMENT OF FACTS

On June 12, 2003, GRPUC filed a petition with the MPUC under Minn. Stat. § 216B.44, seeking to extend GRPUC's assigned service territory to include two annexed areas (collectively "Annexed Areas") that fell within the assigned electric service territory of LCP. Area One was a 56 acre-parcel known as the Stoeke-Maxwell Addition, located in the southeast portion of the city. Relator's Appendix ("R.App.") 11. Area Two, a 362-acre parcel, consisting of the Mississippi Heights and Remer-Deschepper Additions, was located in the western part of the city. R. App. 12. The Annexed Areas contained nearly entirely residential customers – 134 of the 136 existing customers were residential, with two small commercial customers. Hearing Exhibit ("Ex."). 22 at 6. The annexation occurred as part of an Annexation Agreement with the Grand Rapids Township in which a portion of the Township will be annexed every two years. By 2010, the entire Township will be incorporated into the City. R.App. 14; Ex. 20 at 5.

A portion of the Annexed Area included an undeveloped parcel that was platted in 1952 but that had remained vacant. Neither party projected new customers in this undeveloped area. T.251; Ex. 24 at 6; Ex. 1 at 35-36. LCP projected 17 new customers throughout the Annexed Area, without providing any foundation for that projection. Ex. 1 at 35. Mr. Mattei, the Community Development Director for the City of Grand Rapids with over 19 years of experience in the city's community planning, criticized that projection as too high, particularly given the loss of population in the city and the new developments of 104 housing units in other areas of the city that were more likely to develop first. Ex. 20 at 7-8.

Minnesota Statutes section 216B.44 stated four factors to be considered in determining “appropriate” compensation: “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.” The parties agreed on the original cost less depreciation (\$50,024), the integration amount (\$0), and assigned no amount to the “other factors” element. Ex. 24 at 3. But the parties disagreed on calculating the “loss of revenue” factor.

Although not in the statute, the MPUC has determined net loss of revenue through a formula in which the gross revenues are determined. Then, the avoidable expenses, which the displaced utility will no longer incur due to a city’s acquiring the service territory, are subtracted from the gross revenues. *In re Application by City of Rochester*, MPUC No. E-229, 132/SA-93-498 (Order Determining Compensation), at 10 (Nov. 30, 1995) (Relator’s Addendum “Add” at 119). That net revenues figure is reduced to present value, and typically expressed in terms of mills<sup>2</sup> per kilowatt hour of energy consumed. But the formula has evolved into a thirty-some page report filed by engineers, reflecting detailed analysis and computations, which not even the Commissioners knew how to alter. Ex. 20, (DAB-1); Ex. 1 (DRE-1).

#### **Loss of Revenue Evidence.**

The MPUC referred this matter to the Office of Administrative Hearings for a contested case hearing. The ALJ presided over two days of testimony, admitted over 36 lengthy exhibits, and observed eight witnesses testify. The parties agreed to gross revenues in the amount of \$135,425. Hearing Transcript at 195:19 – 197:6 (hereinafter “T.” at page); 201-205. But the parties disagreed on calculating the loss of revenue.

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<sup>2</sup> One mill is the equivalent of one-tenth of one cent (\$.001).

The City recommended loss of revenue for existing customers in the amount of 16.5 mills/kWh, or present value of \$204,402. LCP, by contrast, recommended 35.4 mills/kWh for existing customers and 32.4 mills/kWh for future customers, for a total of \$521,657 present value.

The parties disagreed on three major loss-of-revenue issues: whether LCP should receive compensation for lost revenues from future customers; whether the purchased power costs should recognize the overwhelmingly residential nature of the Annexed Areas, as opposed to an average of the entire system of LCP customers; and whether the avoidable expenses should include costly system improvements such as avoided substation costs and freed up capacity from LCP no longer serving the Annexed Areas.

The parties agreed that there are few vacant lots available within the Annexed Areas. In Area 1, only one residential lot remains undeveloped. R.App. 13. Area 2A has 13 undeveloped lots. *Id.* Citing another LCP employee, without any basis for the number, LCP's expert, Mr. Eicher, predicted a total number of 17 new customers. Ex. 1 at 35-36, DRE-8 (page 1). In the undeveloped northern area, labeled Area 2B in DAB-2, page 3, neither party anticipated customers to locate within the next ten years. T. at 251:10-16; Ex. 24 at 6 (noting LCP's predicted future customers all fall within other areas); Ex. 1 at 35-36, DRE-8 (page 1); *Id.* at DRE-10 (page 17); *see also* R.App. 13 (finding "[n]o development is planned within the next 10 years for the undeveloped portion of Segment 2B").

A second key difference between GRPUC's and LCP's recommendation – over 15 mills – concerned calculating the avoidable expense of purchased wholesale power

costs. T. at 116:21 – 25. The Annexed Areas are overwhelmingly residential – 82% of the energy purchased in Areas was by single-phase residential customers. T. at 41:25 – 42:18. But the entire LCP system, by contrast, is much less residential: only 49% of energy purchased system-wide was by single-phase residential customers. T. at 47:2-16; T. at 48:11 - 25. The load factor for residential customers was significantly lower than for industrial customers. Ex. 24 at 18-20; T. at 39:10-25; T. at 40:12-17. Moreover, LCP's rate structure had number of "special class" customers with high loads that compound the inaccuracy of using "system average" rather than looking at particular classes of the affected Annexed Areas. Ex. 24, DAB-1, at 16 (Exhibit IV of the LCP rate study). The load factor is a significant component of the wholesale rate. T. at 60:4-21; Ex. 3, DRE-6R2, at 5. If the load factor is high, the demand on the wholesale power is less, reducing the avoidable wholesale power costs, and increasing the final award. T. at 58:3-15.

Rather than examining the specific residential classes of customers in the Annexed Areas and their load factors, LCP used a "system average" of the entire LCP customer system to guesstimate the load factor of the Annexed Areas. Ex. 24 at 18:11 – 20:14. Nor did Mr. Eicher ask his client for load data by class. T. at 49:16 – 23. LCP therefore determined wholesale power costs, based upon the system average, at 45 mills/kWh. T. at 53; R.App. at 18.

By contrast, GRPUC used the best data available to determine the load factor for the Annexed Areas – data separated by class of customer. LCP's 2000 rate study, created by the same firm as its expert, detailed the load factor and cost information by class. Ex. 23 at 40. This approach avoided the "special customer class" rates and

focused on the overwhelmingly residential character of the Annexed Areas and reflected the higher rates imposed by LCP for these customers. T. at 210:4-11. Interestingly, Mr. Eicher designed the very wholesale rates at issue in this case. T. at 45:16-19.

When confronted with the dramatic difference between the overwhelmingly residential character of the Annexed Areas as compared to the “system average” character of customers on cross-examination, Mr. Eicher acknowledged that the purchased power expense must be adjusted. T. at 52:19 – 53:20 (“So I do, in fact, have a power cost that is higher than the system average. It certainly would not be – you said 50 percent. That would put it up to 67 mills. . . . It might be higher than 45, but it’s probably not higher than 48, let’s say, or 50. It’s certainly not up in the 60s.”). The amount of the adjustment he testified to was a range, which he ultimately testified “might be 50, but not 60. Is that where you’re at? A. Absolutely.” T. 56:1-4.

By contrast, in its exceptions to the ALJ report, LCP finally provided a specific number for purchased power costs related to class (52.9 mills) – an eight mill difference from its proposed 45 mills that was higher than Mr. Eicher’s vague range of numbers discussed in cross-examination – which would decrease the LCP’s overall award by eight mills. R.App. 40.

Mr. Berg, GRPUC’s expert, in testimony, agreed to LCP’s gross revenues number. That change was based upon two corrections – one that increased total revenue and one that decreased total revenue by slightly greater amount. T. at 195-97. Mr. Berg also agreed there would need to be some adjustments for off-peak sales. T. at 204-06. GRPUC determined the off-peak sales represented an adjustment of 2.73 mills, to be added to the 15.5 mills. Otherwise, adding the number to the 16.5 mills

would count only the correction to off-peak sales on the expense side, but not the corrections to the revenue side. LCP cannot only recognize reduced power cost from off-peak rate without also recognizing reduced revenue from the discounted off-peak rate.

LCP claimed that the 2000 rate study relied upon outdated charges no longer reflected in the cost of service. But LCP witnesses acknowledged that these costs continue to justify the rates charged to the customers within the Annexed Areas. As Mr. Eicher testified in response to the Department of Commerce:

Q. [H]as Lake Country in general lowered its rates to its customers on a general track with the lowered costs it's been incurring in the past 10, 15 years?

A. I believe, I don't know that I can go back 15 years ago, but for the last 5 years or more, Lake Country has increased its rates . . . .

T. at 125:7-13. LCP's rates have not decreased without these charges. Indeed, LCP implemented multiple rate increases since the 2000 rate study. T. at 125, 134, 305. And LCP's costs have decreased. T. at 125. The best information available by class, the 2000 rate study, was used to justify a significantly higher rate.

A third area of disagreement concerned the system investments that LCP could avoid by not having to serve the Annexed Areas. T. at 254:9-21; Ex. 22, DAB-1, at 13-14 (\$51,000 in system investment avoided costs). Mr. Berg investigated three existing LCP feeders, using eleven miles of data to calculate the average LCP cost for backbone feeders. T. at 255:15-23. He then calculated an equivalent cost based upon the kVA of the existing customers. T. at 256:11-15.

Mr. Seeling, a consultant engineer with Mr. Eicher's firm for LCP, testified that two projects by LCP may affect the Annexed Areas, including the CH1 conversion of

line and the new Pokegama substation. T. at 139:19 – T. 140:3. Mr. Seeling acknowledged that the new substation would provide contingency support and backup for other substations. T. at 140:7-13. His analysis supported Mr. Berg's observation that freed up capacity for substations benefited existing substations.

### **LCP's Approach of "Virtual Territorial Protection."**

The LCP Board of Directors resolved to increase its compensation beyond the existing MPUC precedent – notably, 8 mills for future customers -- to break the City's resolve through a prohibitively expensive proceeding, achieving "virtual territorial protection."

WHEREAS, besides challenging the PUC's taking, the co-op is intent on expanding the current compensation formula. The current formula generally provides for loss of margins for ten years and **8 mills for future loads** limited to ten years along with capital and reintegration costs. LCP, in concert with its power supplier, Great River Energy, would seek payment on behalf of the G&T's other 28 distribution co-ops for lost transmission revenues and generation margins. This design has yet to be tested before the Minnesota PUC. If successful, it could well set a precedent for future compensation cases and may well dissuade future taking by Minnesota's acquisitive municipal-owned utilities . . . .

WHEREAS, asserting G&T losses on behalf of its other affected distributions cooperatives represents an opportunity to **achieve virtual territorial protection by increasing the taking cost**. Locally, LCP's request for Integrity Funds will ensure that any future degradation of the co-op's service ar[ea] by the municipal utility will be made more difficult.

Ex. 28 (Nov. 27, 2001 minutes) (emphasis added); T. at 298:2 – 299:12; *See also* T. at 327:3 – 17.

LCP formed an Annexation Committee to deal with the potential acquisition by GRPUC. The Annexation Committee recommended contacting the Chamber of Commerce. T. at 313:5 – 314:10; Ex. 34 (notes dated July 18). GRPUC general manager, Mr. Ward, testified that a member of the Chamber of Commerce contacted

him with the warning that that “GRPUC’s acquisition of the service territory may impact LCP’s decision to locate their service center expansion at their current location just inside Grand Rapids,” which involved 21 jobs. Ex. 17 at 7; see also Ex. 33 at 1 (notes “prepared to relocate HQ”); T. at 318:9-13.

The Annexation Committee also decided to approach county commissioners, township meetings, and the International Brotherhood of Electrical Workers (IBEW) – which represented 80% of LCP’s employees – with the message that “a continual taking of the territory would have an effect on their membership. At least implying that they could lose their jobs over such an issue? That’s correct.” T. at 314:15 – 315:12; Ex. 34 at 2.

#### **Past Benchmarks.**

At the hearing, Mr. Eicher acknowledged that he advised, and participated in a number of earlier service territory cases that resulted in settlements or a MPUC order. R. App. 260-62; 263-64.<sup>3</sup> These compensation numbers have ranged from 6.25 mills to 14.5 mills. R.App 261, 263-64. Mr. Eicher acknowledged he had participated in a number of settlements in which the award fell within that range and agreed that the “bulk of the settlements would be in the seven to eight mill range”. T. at 114:2-3.

Dale Lusti of the Department of Commerce testified that the past settlements and MPUC orders that he compiled in his pre-filed testimony (DVL-4), provide “a range of reasonable outcomes” and “a frame of reference for value by reasonable parties.” T. at 347:19 - 348:1-5.

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<sup>3</sup> The parties agreed to admit as evidence the portion of the transcript in the electric service territory case involving the City of Buffalo that addressed this issue.

Mr. Eicher failed to explain why this case created such a marked departure from past cases.

Q. And there's no particular circumstances or facts in this case that bring it to a level that is nearly five times as high as the bulk of the settlements?

A. My guess is the settlements are simply numbers that are agreed to by the parties and don't have an analysis find . . . .

Q. Can I ask again why is it so high in this case?

A. Simply applied the same methodology that's been used in other cases involving cooperatives and munis and we've come up with this number applying the facts of this case.

T. at 114:13-18; T. at 115:10-13. Indeed, rather than accept any limitation whatsoever on the reasonableness of the compensation award, Mr. Eicher testified that even his recommendation would be *inadequate* compensation for LCP. T. at 23:24 – 24:18; T. at 26:13-16. Only upon further questioning did Mr. Eicher elaborate that some factors affecting the higher award number include lower interest rates, the cooperative's relatively high retail rates, and purchased power costs. T. at 115:14 – 7. None of these factors resided in the control of GRPUC. But the major cited factors resided within the control of LCP.

The record reflected the long-standing approach of considering two times gross revenues as a reasonableness check. Mr. Eicher acknowledged that in the *Shakopee/Minnesota Valley* condemnation case, the award was two times gross revenues. T. at 110:2-10. He agreed that two times gross revenue is a method used to determine compensation. T. at 111:11-21; 112: 1 – 113: 2. Indeed, LCP had consulted with the Minnesota Rural Electric Association, who advised that "the rule of thumb" for the acquisition is "2 to 2½ times the gross revenues per year for each customer."

Hearing Exhibit 29 at 1; T. at 8:3-14; T. at 303:10 – 24. Mr. Eicher’s proposal, by contrast, was 3.24 times gross revenues, or 15 times average margin. Ex. 23 at 32.

#### **The ALJ Report and Recommendations.**

The ALJ found LCP’s proposed award was unreasonable. R.App. 24 (“[T]he compensation rate proposed by [LCP] is unreasonable.”). The ALJ fundamentally concluded that LCP’s approach to compensation overstated its damages. “[LCP]’s application of the *North Park* formula, used to calculate the loss of revenue from those customers, is flawed. . . . The disparity arises from [LCP]’s application of the formula to calculate the loss of revenue.” R.App. 21. The ALJ also concluded that the “formula set out in *North Park* is subject to wide swings in result, based on data that may be insufficiently transparent and insufficiently reliable.” R.App. 27.

The ALJ also found that Grand Rapids has lost population for the period 1990 to 2000. R.App. 12. The ALJ determined that no witness testified that development was likely in the bare ground area over the next ten years. . . . With no future customers identified in the bare ground portion of Segment 2B, no award of lost revenue for that portion of the service area need to be made.” R. App. 17. The ALJ also specifically rejected the system-wide average load factor and found instead that “[t]he record in this matter supports using class-based cost figures from 2000.” R.App. 20. Noting that LCP increased rates in 2000 and 2004, justified due to increased cost of service, the ALJ rejected LCP’s argument that LCP’s costs of service were low, and instead “support[ed] a lower compensation award that that advanced by [LCP].” *Id.*

The ALJ found that LCP’s average system margin for its existing customers was 2.6%. R.App. 20. By contrast, LCP’s recommended compensation for the Annexed

Areas would reflect a margin of 40.4%. *Id.* The ALJ concluded that “[LCP] has provided no satisfactory explanation for the extreme disparity between the system average margin and the margin for its existing customers in two otherwise unremarkable residential areas.” R.App. 21. The ALJ also noted that LCP’s proposed award was 62.9% of what is charged to GRPUC electric customers, which the ALJ concluded “further supports the conclusion that the rate is unreasonable.” R.App. 24.

The ALJ determined that no compensation was appropriate for future customers, given the City’s past decrease in population, the availability of 104 additional developable lots closer to amenities, and the lack of any trait in the Annexed Areas to encourage development. R.App. 21-23. For existing customers, the ALJ recommended two alternatives for the MPUC to decide: following GRPUC’s approach, 15.5 mill/kWh (\$233,820 without adjusting for present value) or a check used by the MPUC in the past, two times gross revenues, \$270,850. R.App. 23. The ALJ noted that the mill rate, based upon “economic modeling,” was unnecessary when “all of the customers to be served over the next ten years are already present.” R.App. 22.

Gross revenue “is a known quantity . . . not subject to the variable factors due to newly-served customers that must be arrived at through modeling.” R.App. 23. The ALJ reasoned that multiplying gross revenues by two, a check applied by the MPUC and parties in past cases, provided “significant benefits” because “[t]here are no opportunities for ‘normalizing’ costs in ways that distort the calculation.” *Id.* The ALJ also noted that “[c]ooperatives have now changed their policies to shift the calculation of costs in response to the formula. The effects of these policy changes has been to significantly increase the proposed compensation for lost revenue [to] be paid by

municipal utilities . . . .” R.App. 23. The ALJ found that GRPUC’s “assessment of costs more accurately identifies the actual costs avoided by [LCP] in no longer serving the customers in Areas 1 and 2.” *Id.* The ALJ also concluded that the similarity in result from either a mill rate or two-times-gross-revenues “lends further support to the City’s approach to the calculation.” R.App. 23-4.

**The MPUC Hearing.**

At the hearing on August 4, 2005, only four Commissioners were present. Two of the four Commissioners voiced displeasure with the municipal’s statutory right to acquire service territory. Chair Koppendrayer commented:

Rural electrification has a long and very good result. . . . as the City expands, and you say the City is expanding, here’s some folks I want to serve, here’s a commercial area I want to serve . . . .if you do this in every community, all that the Co-op is left with is some very difficult-to-serve rural areas . . . .Consequently go cherry pick and drive costs up, and in the long run it’s not a good deal when someone can take someone else’s territory. . . .”

R.App. 133 (T. at 60). There was no evidence in the record of cherry-picking in the present case; GRPUC petitioned to serve the Annexed Areas subject to the orderly annexation agreement. Ex. 20 at 5. Chair Koppendrayer also noted that “[t]here’s a great disparity between the Co-op and the municipality here in looking at it . . . .but I don’t have an argument with how the Co-op put together their numbers.” R.App. 140 (T. at 88).

Commissioner Johnson also indicated that the cooperative should receive whatever damages it wants, given the municipal’s acquiring by statute. “The Co-op wants this number. They don’t want to sell it, but they’ll take that number because they have to by law. . . [S]o why not give the Co-op what they want for it?” R. App. at 142 (T.

at 96-97). This position allows no check for reasonableness. Indeed, it assumes that only one party need participate in the process, rather than an adversary proceeding.

Commissioner Nickolai, by contrast, noted concerns with LCP's damages in light of the record.

I am concerned about two issues in particular in the application of the formula, one is using that system average and the load factor and how that inflates the compensation, and then also about the reduction – elimination of those expenses, those GRE-related [wholesale power costs that LCP claimed were no longer in effect] expenses that also ends up inflating the compensation . . . . And I'm just not persuaded that there's enough evidence here for us to say, well, here, we should just remove that without – without anybody establishing that, in fact, that there are those other costs still there.

R. App. 137-8 (T. at 75, 81). A motion to adopt LCP's proposed award failed on a 2 to 2 tie vote. R.App. 141 (T. at 92).

Staff was asked how to adjust the wholesale power costs in terms of load factors, but not in terms of claimed additional costs. Staff referenced only Mr. Eicher's testimony, in two locations, rather than the higher amount calculated in LCP's exceptions. Even so, staff ultimately noted the difference for this one factor would be 6 mills, for a total award of 29 mills. R. App. 138 (T. at 78-9) ("What it suggested to me was that an appropriate subtraction for that, if there is to be one, would be about 6 mills.")' *see also* R. App. 139 (T. at 84) ("The difference between the 46 and the 52 is 6.").

There was considerable confusion in adjusting the formula to reflect the change in the mill rate due to load factor consistent with the Annexed Areas. Commissioner Reha could not account for 2.6 mills, and the ultimate "answer" made no sense. R.App. 140-41 (T. at 86, 90) ("It has to do with the ALJ not giving any credit for any future

customers. . . And he found no compensation was due, so that's where my plus 2.6 mills comes in."). In the end, Commissioner Reha proposed an award of 30 mills. R.App 143 (T.98). Discussion akin to bargaining ensued.

Commissioner Johnson: A week ago I came up with 30.5.

Commissioner Reha: We're awful darn close, aren't we?

Commissioner Johnson: Well, if you want to go up a half a point?

R. App. 143 (T. at 99).

The MPUC ultimately awarded 30 mills, on a three-to-one vote, with Chair Koppendraye opposing the motion. R. App. 143 (T. at 100). Commissioner Johnson then stated "I really – can I take my vote back? I don't like it." *Id.* The vote remained.

#### **The MPUC Order.**

The Order rejected the sum and substance of the ALJ's report, including the finding that LCP's proposal was unreasonable. R.App. 148. The Order expressly adopted LCP's proposed award, with a minor modification. *Id.* at 150, 159. The Order resolved the parties' over 15 mill difference in purchased power costs by a 5 mill decrease from LCP's original proposal. The Order rejected each of four proposed reasonableness checks on the award as "non-probative". R.App. 151, 153, 154. The Order did not apply any reasonableness check to the award. Instead, it adopted LCP's recommendation with a 5-mill adjustment. R. App. 150, 159. The Order required compensation for future customers in the undeveloped area – despite the record that no party or evidence supported future customers there. R.App. 155-56. The Order quoted from another service territory decision involving the City of Buffalo, although that case

concerned only eight existing customers and some 500 projected new customers, unlike the all-existing customers in the present case.

Curiously, the Order agreed “with the City that it is unnecessary to use system-average costs when actual costs are clearly different and can be determined with reasonable accuracy.” R.App. 159. But the Order did not determine the actual costs. Instead, it criticized GRPUC’s use of the 2000 rate study, which included some charges that LCP claimed are no longer being paid. But the Order did not address LCP’s failure to decrease its rates when those charges were no longer required, a concern raised by Commissioner Nickolai. See T. at 217:14-15; 217:21 – 218:6; 218:22-25 ; 228:5-10 (LCP has not decreased its rates to reflect the decrease in charges). Nor did the Order consider that the 2000 rate study was the best available evidence of class data for the Annexed Areas. It incorrectly stated that the evidence “do[es] not exist. R.App. 162. The record instead reflected that LCP did not determine if the data was available. T. at 49:16 – 23 (Q. “So you don’t know what was asked and you didn’t ask? A. No, I did not.”). And the Order incorrectly characterized GRPUC’s analysis of system improvements as based upon the 2000 rate study allocations. R.App. 148. In terms of system improvements, the only data used from the rate study were estimates of peak demand and monthly consumption. Exhibit DAB-1 at 14.

The City filed a petition for rehearing and reconsideration. R.App. 164. The MPUC did not move to reconsider or conduct a rehearing on the petitions, and pursuant to Minn. Stat. § 2126B.27, subd. 4, the petition was automatically deemed denied. The City filed a petition for writ of certiorari. R.App. 236.

## STANDARD OF REVIEW

On legal issues such as statutory interpretation, this Court reviews agency decisions de novo. *No Power Line v. Minnesota Env'tl Quality Council*, 262 N.W.2d 312, 320 (Minn. 1977); *In re Denial of Eller Media Company's Applications*, 664 N.W.2d 1, 7 (Minn. 2003) ("We retain the authority to review de novo errors of law which arise when an agency decision is based upon the meaning of words in a statute.").

Although the Court may grant some deference to matters within the agency's technical expertise, *Reserve Mining v. Herbst*, 256 N.W.2d 808, 824 (Minn. 1977), in reviewing contested case proceedings, this Court must "conduct an independent examination of the administrative agency's record and decision" and determine whether the agency's "factual findings are supported by substantial evidence, whether its decision is lawful and reasonable and unaffected by errors of law, and whether its conclusions are arbitrary and capricious." *Appeal of Signal Delivery Serv.*, 288 N.W.2d 707, 710 (Minn. 1980); *Cable Communications Bd v. Nor-west Cable Communications*, 356 N.W.2d 658, 668 (Minn. 1984).

## SUMMARY OF THE ARGUMENT

Without any check on the reasonableness or appropriate value of the result, the MPUC determined the highest electric service territory award in Minnesota history. The Order rejected four reasonableness checks from an experienced ALJ. The order failed to consider that the traditional mill rate, and the alternative, two times gross revenues, were reasonably close in result. The MPUC failed to consider any check to the award to assess its reasonableness. The order constitutes an unconstitutional violation of GRPUC's due process rights to reasonable compensation awards.

Moreover, the order was arbitrary and capricious in awarding loss of revenue for future customers in areas in which no evidence supported customers. The award was arbitrary and capricious in overruling ALJ findings of an unreasonable proposal by LCP, of manipulating the formula, and credibility findings in favor of GRPUC. And the award was arbitrary and capricious in inverting the law, which specifically allows municipals to expand and grow with their cities. Minn. Stat. § 216B.44. Two of four Commissioners expressed their dislike of the statute, raising questions as to the impartiality of the decision.

The MPUC also erred as a matter of law in applying the statutory factors of section 216B.44 to understate the purchased power expense. The MPUC simply adopted as truth LCP's expert (contrary to the ALJ's credibility findings) imprecise range of corrected purchase power expenses, without considering the specific correction he made after the hearing that would change LCP's proposal by eight mills. Using LCP's own numbers, the ultimate award should be eight mills lower than LCP's recommended award. At the very least, ignoring the precise and higher number of LCP was contrary to the evidence, reflecting arbitrary action.

Finally, the MPUC erred in applying section 216B.44 to determine LCP's costs in no longer serving the Annexed Areas. The MPUC improperly allowed LCP to escape the full costs of service. It failed to consider evidence of the significant costs of service. And it failed to recognize the full system improvement expenses that LCP will avoid, incorrectly dismissing GRPUC's factually supported analysis as "averaging/allocating" rather than the incremental approach advanced by GRPUC.

## ARGUMENT

### I. THE MPUC AWARD, WITHOUT ANY REASONABLENESS CHECK, WAS UNCONSTITUTIONAL, ARBITRARY, AND CAPRICIOUS.

This Court must reverse a decision that is unconstitutional or arbitrary or capricious. Minn. Stat. § 14.69(a), (f). The MPUC failed to consider any reasonableness check on the largest service territory award in Minnesota history. The MPUC's approach violated GRPUC's constitutional due process rights and created an arbitrary and capricious decision.

#### A. THE AWARD WAS UNCONSTITUTIONAL.

Due process requires reasonable damages in any civil proceeding. *Flanagan v. Lindberg*, 404 N.W.2d 799, 800 (Minn. 1987); see also *Knox v. City of Granite Falls*, 245 Minn. 11, 72 N.W.2d 67 (1955) (remitter appropriate when evidence does not justify the damages). Even punitive damages – by their nature designed to “punish” the offending defendant – if excessive, violate the Due Process Clause of the Fourteenth Amendment. *State Farm Mutual Automobile Insurance Co. v. Campbell*, 538 U.S. 408, 426 (2003); *Jensen v. Hercules, Inc.*, 524 N.W.2d 748 (Minn. App. 1994).

A new trial on damages will be ordered where an award is so excessive or inadequate that “it could only have been rendered on account of passion or prejudice.” *Id.*; see also *Knox v. City of Granite Falls*, 245 Minn. 11, 72 N.W.2d 67 (1955)(“[e]ven though passion and prejudice are absent, appropriate action may be taken where the evidence does not justify the award of damages); *In re Imprv. of Third St. Saint Paul*, 225 N.W. 92 (Minn. 1929)(setting aside condemnation award as unfair and impartial because award was grossly disproportionate to the value of the land taken).

By statute, the MPUC must determine “appropriate value.” Minn. Stat. § 216B.44. The MPUC has expressly noted that the compensation awarded to a cooperative must be reasonable. *Olivia*, MPUC Docket No. E-288, 136/SA-85-93 Order after Rehearing, at 10 (Oct. 1, 1986) (Add. 63). Rather than follow this precedent, the MPUC’s Order appeared to adopt LCP’s view that its formula has no limit. In the words of LCP’s expert, “Simply applied the same methodology . . . and we’ve come up with this number. . . .” T. at 115:10-13. Judge Davies’ dissenting opinion in the *North Park* case warned against punitive service territory awards. *North Park*, 470 N.W.2d at 525 (Davies, J., diss.) (“If cities are to be free to extend service to annexed areas, however, the cost of doing so must be reasonable, not punitive.”).

Respondents are likely to cite to a recent unpublished decision from this Court in an electric service territory matter that affirmed the MPUC order. See *In re Application of the City of Buffalo to Extend its Assigned Service Area into the Area Presently Assigned to Wright-Hennepin Cooperative Electric Association*, Unpub., No. 05-1410 (May 9, 2006), *review denied* (Minn. July 19, 2006) (Add. at 22). But that decision is not binding in the present case. Minn. Stat. § 480A.08, subd. 3 (“Unpublished opinions of the Court of Appeals are not precedential.”). Moreover, the Court expressly declined to address the City of Buffalo’s arguments concerning the unconstitutional, arbitrary, and capricious nature of the award, as “premature,” given the lack of a final award number from the MPUC. Add. at 30.

In the present case, even the experts struggled to explain why the numbers are so high. Mr. Eicher testified that he “[s]imply applied the same methodology . . . and we’ve come up with this number . . . .” T. at 114:13-18; T. at 115:10-13. Due process

and the “appropriate” language in section 216B.44 demand a stringent review of the reasonableness of the result, not plugging in numbers.

The neutral party in the proceedings, the Department of Commerce, repeated its warnings in the *Buffalo* case that given the dramatic difference between from earlier cases, it was appropriate to consider re-evaluating the use of the formula. R.App. 251 (“In this case, the results are between 400 and 500 percent higher than the average historical mill rate used. The Department recommends that these differences should be adequately explained in order to justify a finding that the Cooperative’s proposed mill rate is reasonable in this case.”); R. App. 254 (“Mr. Eicher’s model may no longer be appropriate to use, if its results continue to greatly exceed what have been generated fairly consistently over the past 13 years.”).

The express adoption of LCP’s award, without any reasonableness checks, is particularly troublesome in the present case given the long-term orderly annexation agreement with the Township in which Grand Rapids will annex areas every two years. Ex. 20 at 5. GRPUC apparently must face ever-increasing awards without basis or a reasonableness check, but simply a “plugging in” of numbers by one party.

The MPUC’s failure to consider any reasonableness check on the compensation awarded to LCP – contrary to the statutory requirement to determine “appropriate” damages – violated the City’s due process rights.

#### **B. THE AWARD WAS ARBITRARY AND CAPRICIOUS.**

This Court must reverse a decision that is arbitrary or capricious. Minn. Stat. § 14.69(f). An agency decision is deemed arbitrary or capricious if it reflects the agency’s will, rather than reasoned analysis. *In re Space Ctr. Transp.*, 444 N.W.2d 575, 581

(Minn. App. 1989); *Mankato v. Mahoney*, 542 N.W.2d 689, 692 (Minn. App. 1996). Courts have determined an agency's decision to be arbitrary and capricious if it relied on factors not considered by the Legislature, failed to consider an important aspect, provided an explanation contrary to the evidence, or was so implausible that it cannot be explained as a difference in view or the agency's expertise. *Brown v. Wells*, 288 Minn. 468, 472, 181 N.W.2d 708, 710-11 (1970). This Court must conduct a "searching and careful' inquiry of the record to ensure that the agency action has a rational basis." *Manufactured Hous. Institute v. Petterson*, 347 N.W.2d 238, 244-45 (Minn. 1984) (holding agency's unexplained selection of maximum level arbitrary).

In the present case, the MPUC arbitrarily determined that GRPUC must pay LCP for future customers in an undeveloped area platted since 1952 where no evidence supported future customers. R.App. 155; T. at 251; Ex. 24 at 6; Ex. 20 at 2-3. The MPUC also accepted LCP's projection of future customers, which was offered without any foundation. Ex. 1 at 35-36. Instead, GRPUC's Community Development Director noted that even using an historic growth rate was "generous" given the decline in the city's population and the new developments of 104 housing units in other areas of the city that were more likely to develop first. Ex. 20 at 7-8. Imposing an award on future customers in areas unsupported by the record demonstrates an arbitrary decision.

Moreover, the MPUC's blind reliance on "the formula" and whatever number it may produce is arbitrary and capricious and without statutory authority. The formula is not contained within section 216B.44. Nowhere does it appear in the law. The law instead requires "appropriate value." Minn. Stat. § 216B.44. The arbitrary and capricious result may be measured in four ways, each rejected by the MPUC.

**First**, past MPUC decisions and party settlements in the range of seven to eight mills constitute one proposed reasonableness check. T. at 114:2-3. The Department of Commerce submitted such a listing as a “frame of reference” for value. T. at 347:19 - 348:1-5; Ex. 35, DLV-4; DAB-6. The listing reflected a range of seven to eight mills. The Board of Directors of LCP even noted that the “current formula” produced 8 mills for future customers. Hearing Ex. 28. The MPUC has held that similar service territory should result in similar compensation awards. *Olivia*, MPUC Docket No. E-288, 136/SA-85-93, Findings of Fact, Conclusions of Law, and Order Setting Compensation for Service Extension, at 15-16 (June 27, 1986) (reasoning MPUC must avoid “different loss of revenue awards for two nearly identical acquired areas.”) (Add. 49-50).

The Department of Commerce noted the great discrepancy between the compensation recommended in the present case and past cases, and again cautioned that it would be appropriate to consider whether to continue using the formula. R. App. at 254 (noting results in this case are 400 – 500% higher than average historical mill rate). Mr. Eicher, by contrast, testified that LCP’s proposed award was “inadequate.” T. at 23:24 – 24:18.

**Second**, the ALJ provided an alternative analysis, based on the MPUC’s and parties’ past use of a gross revenues multiplier approach. The ALJ Report reasoned that this alternative approach was preferable for mature service territories, such as the Areas at issue in this case, and provided a more accurate method, given the evidence of manipulation of costs under the “formula” approach. R. App. at 22-3.

The record supported the ALJ's use of this alternative approach. In cross-examination, Mr. Eicher admitted that past cases had used the two-times-gross-revenues approach as a reasonableness check. T. at 110:2-10. He also admitted that two times gross revenue is a method used to determine compensation. T. at 111:11-21. He acknowledged that past settlements have been based on two times gross revenues. T. at 112: 1 – 113: 2. And LCP itself was aware of this approach. The Minnesota Rural Electric Association advised LCP that "the rule of thumb" for the acquisition is "2 to 2½ times the gross revenues per year for each customer." Ex. 29 at 1. The MPUC specifically reasoned in the *Olivia/Renville Sibley* matter that a gross revenues multiplier "is useful as a check on the reasonableness of the results." Add. At 51.

In the present case, however, the MPUC absolutely rejected this approach, both in terms of determining an award and as a reasonableness check. The MPUC reasoned that applying a multiplier of three would not support LCP's proposal as unreasonable. R. App. 153. But LCP's proposed award was 3.5 times gross revenues, higher than past checks. Ex. 23 at 32. And the MPUC ignored the evidence of other parties, in condemnation and in settlement, using the two times gross revenues as a reasonableness check. The MPUC had looked to past settlement practices in other situations. *See In re Application of Rochester*, No. E-299,132/SA-93-498, at 5 (Nov. 30, 1995) (noting although MPUC had not used direct net revenue loss method, "it has been used by parties in settlements" and adopting approach). The MPUC also ignored LCP's own expectations of "2 to 2½ times gross revenues" or 8 mills/kWh. Ex. 29; Ex. 28. Instead, the MPUC apparently adopted LCP expert's position that no limit whatsoever applies to the reasonableness of the award, and that even its record

proposal was “inadequate.” T. at 23:24 – 24:18; T. at 26:13-16. The MPUC’s disavowal of its past decision and the past practices of parties, without any alternative reasonableness check on the award, reflects arbitrary action.

**Third**, GRPUC and the ALJ compared the margin or profit associated with all LCP customers with that recommended as damages for the specific customers in the present case. Ex. 23 at 31-33; R.App. 20. The difference was stark. On its total system of customers, LCP earns 2.6% in average margin or profit. Ex. 23 at 32. By contrast, LCP proposed an effective margin for the customers within the Annexed Areas of 40.4%, over 15 times greater than for its average system. *Id.* The MPUC rejected this analysis as providing “no meaningful comparison” because the 40.4% figure included “costs [that LCP] formerly recovered in revenues from the annexed areas which it continues to incur. . . .” R. App. 151. But the MPUC did not consider that it has used such an approach in the past. In the *Olivia* case, after rehearing, the MPUC reasoned that “the margin reflected in the Commission’s loss of revenue award is substantially less than the total margin generated from the area in 1984.” *Olivia*, Order after Rehearing, at 5 (Oct. 1, 1986) (Add. 58).

Moreover, GRPUC expressly acknowledged that a higher number than the system average margin would be expected. Indeed GRPUC’s expert analysis represented an incremental margin of 19.7% for the Areas, as opposed to 2.6% for the LCP system. Ex. 23 at 33. The number for the Annexed Areas would be somewhat higher, but over 15 times greater than the system average margin was considered unreasonable on its face. Ex. 23 at 33. The MPUC refused to consider the magnitude

of this difference. It declined to consider what could be so different about these two residential parcels to create such a dramatic difference in margin.

*Fourth*, GRPUC and the ALJ considered the reasonableness of the proposed award in terms of GRPUC's average retail rate. LCP's position reflected 62.9% of GRPUC's average retail rate. Ex. 23 at 34. In other words, LCP asked the city's customers to endure a nearly two-thirds markup in their rates to pay for the Annexed Areas. The MPUC rejected the ALJ's finding, not as factually inaccurate, but as "untethered" to the statutory factors of section 216B.44. R. App. 154. But the MPUC failed to consider its past precedent that "Minn. Stat. § 216B.44 (1984) requires, to the extent possible, equitable treatment of the buyer and seller." *Olivia*, Order Setting Compensation, at 13 (Add. 47); *id.*, Order after Rehearing, at 10 ("If the Commission were to pass through all or most of the benefit of expected growth to the Cooperative in the acquisition price, the City probably would be forced to abandon the acquisition.") (Add. 63). The Commission has also noted that customers within the annexed areas "are paying a margin greater than their counterparts elsewhere in the Cooperative's service area. . . . [T]he Commission must treat these customers in the annexed area fairly." *Olivia*, Order Setting Compensation, at 13 (Add. 47). And the Commissioners' debate at the MPUC hearing can only be described as outcome-driven, unconnected to the statute. R. App. 124 (T. at 99).

The MPUC's rejecting four proposed reasonableness checks, without considering any reasonableness check, represented arbitrary action. The MPUC by default favored the LCP approach of no check, and that even its proposed number was inadequate. T. at 23:24 – 24:18; T. at 26:13-16. The MPUC made no effort to consider

or evaluate whether the award was reasonable. It made no effort to explain how the present award differed dramatically from past precedent of MPUC orders and parties' settlements, nor responded to the Department of Commerce's concern with the excessive results produced by the formula. The Order represented agency whim, rather than reasoned decision-making.

### **C. THE MPUC IMPROPERLY OVERRULED ALJ CREDIBILITY FINDINGS.**

The ALJ Report clearly resolved the conflicting testimony between the parties' expert witnesses in favor of Mr. Berg, GRPUC's expert. R. App. at 25 (Conclusion 7) (concluding the City's "method for calculating net revenue is more accurate than Lake Country's"); R. App. 20 (Finding 36) (adopting City's class-based power expenses); *Id.* (Finding 39) ("Lake Country has provided no satisfactory explanation for the extreme disparity between the system average margin for its existing customers in two otherwise unremarkable residential areas."); R. App. 21 (Finding 41) ("Lake Country's application of the North Park formula . . . is flawed."); R.App. 23 (Finding 48) ("City's assessment of costs more accurately identifies the actual costs avoided"); R.App. 24 (Finding 51) ("[T]he compensation rate proposed by Lake Country is unreasonable.").

Moreover, the ALJ Report expressly noted the concern that LCP had manipulated data or policies to present its compensation recommendation. R. App. 21 (Finding 41) ("The disparity arises from Lake Country's application of the formula to calculate the loss of revenue."); *Id.* (Finding 43) ("Lake Country's application of the North Park formula, used to calculate the loss of revenue from those customers, is flawed."); R. App. 23 (Finding 47) ("Cooperatives have now changed their policies to shift the calculation of costs in response to the formula."); R. App. 22-3 (Finding 46)

(noting gross revenue multiplier avoids “opportunities for ‘normalizing’ costs in ways that distort the calculation.”); R.App. 27 (reasoning “straightforward formula set out in North Park is subject to wide swings in result, based on data that may be insufficiently transparent and insufficiently reliable.”).

The MPUC’s blanket rejecting these findings – coupled with the statements of two of the four Commissioners at the hearing against a city’s acquiring electric service territory – provide at best a disturbing disregard for sound testing of the result and at worst demonstrate bias or confirm the ALJ’s findings of improper conduct.

Credibility determinations are properly the province of the one who has observed the witnesses testify. See, e.g. Minn. R. Civ. P. 52.01 (“due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses.”); *Denny v. Minneapolis American Indian Center*, 524 N.W.2d 474, 477-78 (Minn.App.1994) (concluding for witness credibility, reviewer must explain why the referee’s findings merit reversal); see also *Tuff v. Knitcraft Corp.*, 520 N.W.2d 483, 486 (Minn.App.1994) (requiring reviewer to specify reasons for rejecting referee’s findings on witness credibility); *Trebelhorn v. Minneapolis Cable Systems, Inc.*, 380 N.W.2d 237, 239 (Minn. App.1986) (expressing “deepening reservations” about deference to a commissioner’s representative that rejected a referee’s findings on witness credibility); *Beaty v. Minnesota Board of Teaching*, 354 N.W.2d 466, 472 (Minn.App.1984) (ALJ recommendations or findings “should not be taken lightly.”); *In re Hutchinson*, 440 N.W.2d 171, 176-77 (Minn.App.1989) (stating when agency conclusions differ from hearing examiners, reviewing court will more critically review the agency’s findings).

By discounting the express credibility findings well grounded in the record, the MPUC has acted arbitrarily and without evidentiary support. The findings are not limited to the expert's methodologies, unlike the *Buffalo* decision. *Buffalo*, R-Add at 29. Moreover, the analysis in the *Buffalo* decision is neither binding nor persuasive. Even assuming that the credibility findings can be construed as relating to the expert's methods, the experts presented their "methodologies" as testimony and in evidence for analysis and adoption. The ALJ's repeated findings and conclusions concerning LCP's manipulating the formula and its results require a searching review of the MPUC's decision to dismiss the findings.

The function of an expert is to assist the fact-finder in reaching correct conclusions from facts in evidence. *Hudson v. Snyder Body, Inc.*, 326 N.W.2d 149, 154 (Minn. 1982). An expert's credibility is necessarily linked to the weight given by the ALJ to that expert's methodology. The ALJ's specific credibility findings are indeed relevant and worthy of deference, as they address the sole offering of the witness – his methodology.

Given the ALJ's ability to observe all witnesses, in the context of the full factual record presented, the MPUC acted arbitrarily in summarily rejecting the ALJ's explicit determinations of witness credibility.

#### **D. THE MPUC'S ORDER INVERTED THE LAW.**

The statute creating assigned electric service territories explicitly stated an intent "to eliminate or avoid unnecessary duplication of electric utility facilities . . ." Minn. Stat. § 216B.37. And it also created an exception specifically for municipal utilities to grow with their cities. Minn. Stat. § 216B.44 ("Notwithstanding the provisions of sections

216B.38 to 216B.42 [assigned service territory], . . . the municipality shall thereafter furnish electric service to these areas”).

The MPUC's Order inverted these two principles of law, instead creating a law of perverse incentives. *Helvering v. Hammett*, 311 U.S. 504, 510-11 (1941) (courts may limit statute if literal approach “would lead to absurd results or would thwart the obvious purpose of the statute.”); *Salute v. Stratford Greens Garden Apts.*, 136 F.3d 293, 297-8 (2d Cir. 1998) (narrowing fair housing act provision that would create perverse incentive to evict Section 8 tenants); *North Park*, 470 N.W.2d at 533 (Davies, J., diss.)(noting result contrary to service territory statutes); see generally James E. Ryan, *The Perverse Incentives of the No Child Left Behind Act*, 79 N.Y.U. L. Rev. 932, 944-952 (2004) (explaining how applying provisions of Act create perverse incentives that undermine the goals of the Act).

Moreover, the MPUC's Order undermined service territory stability and reasonable negotiations. If one party has nothing to lose (its numbers, no matter how high or unreasonable compared to past cases, are likely to be accepted), then it has no reason to negotiate in good faith and come to reasonable agreement. Unreasonable negotiating tactics and “stand-still” agreements halting any city growth of service territory reveal that a one-party-winner system cannot support fair negotiations. *In re Application of City of Lake Crystal*, MPUC No.: E-104,262/SA-01-755 (addressing service territory stand-still provision); Ex. 28. Indeed, LCP's seeking “virtual territorial protection” by making this proceeding prohibitively expensive, and in forming a committee whose tactics included threats of job loss and withdrawn economic development, are clearly contrary to the purposes of section 216B.44. The MPUC's

Order has provided a perverse incentive for recalcitrant parties that refuse to negotiate a reasonable settlement. And the comments of two Commissioners at the hearing indicating their displeasure with the statute were striking. But personal preference cannot supplant the statutory rights in section 216B.44.

The MPUC's Order has the result of unduly burdening cities exercising their statutory rights – contrary to plain language of the law allowing municipals to grow with their cities. Instead, the Order results in compensation awards with no check on reasonableness.

## **II. THE MPUC ERRED IN DETERMINING AVOIDABLE POWER COSTS.**

The Court must reverse agency decisions that are contrary to statutes or “affected by other error of law.” Minn. Stat. § 14.69(d). The greatest single item of difference between the parties was calculating purchased power expenses as a component of LCP's avoidable expenses, a difference of over 15 mills/kWh. The MPUC has previously reasoned that factors such as purchased power costs should not dictate compensation. “One utility should not receive a higher acquisition award than another, for example, simply because it has higher purchased power costs.” *Olivia*, Add. 51.

Although LCP provided no precedent to the ALJ or the MPUC before its initial decision concerning the past use of system-wide averages in the net loss of revenue formula, in response to GRPUC's petition for rehearing, it cited three past MPUC cases. But the decisions did not support LCP's approach in the present case. Although LCP cited to the *Olivia* case, the MPUC there noted that cooperative's approach as a “system average power cost” but the MPUC itself expressly rejected that cooperative's

approach. *Olivia*, Add. 39, 41, 42, 48 Order Setting Compensation, at 5, 7, 8, 14 (“The MMUA argued . . . [for] an allocation of costs based on the customer levels and peak demand in the annexed areas as compared to the Cooperative’s system as a whole. . . . The ALJ indicated that the MMUA’s residual expense methodology is appropriate . . . . The Commission agrees with the ALJ’s conclusion . . . .”). The other two cases did not support LCP’s approach in this case. *In re Application of City of Rochester*, MPUC No. E-299,132/SA-93-498, ALJ Findings of Fact, at 7 (May 31, 1995) Add. 71 (avoided power costs “calculated by applying the rates of the utility losing the acquisition area to the anticipated usage of the area, including energy sales and losses in demand charges.”), *affirmed*, MPUC No. E-299,132/SA-93-498 (Nov. 30, 1995) (no discussion of purchased power costs) (Add. 110); *In re Petition by City of Rochester*, MPUC No. E-132-299/SA-02-496, Order Determining Compensation, at 7 (June 19, 2003) (holding “avoided purchase power expense. . . . can be readily determined without resorting to system averages or other estimation procedures.”)(Add. 130). In the present case, the MPUC made no reference to its past cases. Instead, Commission Reha incorrectly stated at the hearing that MPUC’s past approach was to use system averages. R. App. 140 (T. at 87-88).

Only the City used the best information available to avoid purchased power costs driving the compensation figure. Mr. Berg used data from Mr. Eicher’s firm in the 2000 rate study for the various classes of customers because it provided the best data available for the cost of wholesale power by class. Moreover, LCP set the rates for the existing customers – higher than most rates in Minnesota -- based on the estimated costs in the rate study. To avoid a mismatch between the estimated revenues and the

estimated wholesale power costs for serving the same set of customers, the wholesale power cost estimate by class should be used.

Mr. Eicher, by contrast, estimated the wholesale power cost reduction based on average system wholesale power costs and load characteristics, rather than the estimated wholesale power costs specific to the class of customers in the Annexed Areas. Ex. 3 (DRE-6R2 at 4). But the system-wide, generalized costs do not account for the number of special rate customers (not included in the rate study' base cost of service) who have unique load characteristics. See Ex. 24, DAB-1 (revised 06-23-04), at 16 (Exhibit IV of the LCP rate study). Given the significantly residential character of the Annexed Areas, and the many special rates throughout the system, it was inappropriate to use average wholesale power load characteristics rather than data specific to the Annexed Areas.

In cross-examination, Mr. Eicher agreed that his power expenses should be adjusted. T. 56:1-4. Although he declined to provide a specific number at the hearing, in submissions to the MPUC, LCP offered new evidence calculating the wholesale power expenses at 52.9 mills/kWh, a marked change from Mr. Eicher's original 45 mills/kWh expense estimate, and a greater adjustment than his testimony at the hearing. R.App. 40. By LCP's own admission, the mill rate should have been adjusted by at least eight mills to reflect the use of load factor specific to the Annexed Areas. *Id.*

But the MPUC did not rely upon this late correction. Instead, it used the lower and vague range offered by Mr. Eicher in cross-examination. Nor did the MPUC consider that the claimed "no longer charged" expenses in the 2000 rate study<sup>4</sup> were

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<sup>4</sup> Similarly, LCP provided no factual support for its argument that GRPUC's use of the 2000 rate study improperly "double-counted" administrative expenses. Avoided

nonetheless used to justify the current rates to the Annexed Areas, without any deduction in rates. Nor did the MPUC consider its own past precedent rejecting system-average for purchased power expenses. Instead, the MPUC speculated that "other, new" expenses must have taken the place of the outdated charges, without any support whatsoever in the record. R. App. 138-9 (T. at 81-82). That speculation was reduced to writing in the order as "apply[ing] its judgment to make the most reasonably accurate determination possible." R.App. 162. The record instead reveals that the MPUC unconditionally adopted Mr. Eicher's untested, imprecise range in testimony, rather than his own greater adjustment of eight mills. R. App. 141-2 (T. at 93-94); R.App. 162. This approach constitutes legal error, or at the least, fails for departing from evidence in the record.

Moreover, the MPUC's approach of approving LCP's proposed award, with a modified five mills for power costs, without explicitly rejecting the system-average approach, is inconsistent with the MPUC's use of "incremental" expenses for all other avoidable costs. R. App. 159 ("costs must be calculated incrementally, since not all the fixed costs allocated to particular customers will go away with the departing

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administrative and general expenses were determined in the "498 Case" to be a de minimis amount of one dollar per customer per month, which the City applied in the present case. *In re City of Rochester*, MPUC No. E-299, 132/SA-93-498, at 9 (ALJ Findings of Fact, May 31, 1995) (Add. 73); Ex. 22 at 17, 21. The administrative and general expenses were described in the "498 Case" as including "salaries, office supplies, outside contracting activity, and miscellaneous general expenses", "capital credits recordkeeping activities in the printing and distributing the cooperative's newsletter", and "[m]aterials and supply costs, cost of printing and distributing newsletters". *Id.* at 9-10, ¶¶ 37-38.

But in the present case LCP separately allocated costs affiliated with its wholesale power costs. Ex. 25, DAB-1, at 15 (describing power supply costs). Such costs are not included within the de minimis expenses noted in the "498 Case." Instead, LCP separated, and separately allocated, certain costs specific to its wholesale power costs. *Id.*

customers.”). If a system-wide analysis is indirectly upheld for power costs, the system costs of all other expenses – including operation and maintenance costs, administration, interest, depreciation – should control. Otherwise, the net effect of the MPUC approach is to minimize the displaced utility’s expenses by confining them to “incremental” charges and further minimize the largest expense, purchased power, when benefited by the system. Such an approach is erroneous as a matter of law and arbitrary and capricious.

The MPUC erred in blindly relying upon LCP’s vague range of an award and reducing it by five mills, in considering speculation rather than facts in the record, and in failing to follow its past precedent.

**III. THE MPUC ERRED IN APPLYING THE STATUTORY FACTORS OF SECTION 216B.44 BY NOT CONSIDERING THE TRUE COSTS OF SERVICE THAT LCP WILL AVOID.**

Section 216B.44 states that the MPUC “shall consider . . . loss of revenue to the utility formerly serving the area.” The MPUC’s approach claims to consider the expenses that the displaced utility will avoid by not serving the utility, with a goal of placing the utility “in the same position it would have occupied but for the loss of service rights. . . .” R.App. 147. But the MPUC failed to even consider the full cost of service that LCP will avoid.

**A. AVOIDED COSTS OF SERVICE.**

GRPUC relied upon new evidence concerning the significant costs to serve. For example, the City of Rochester paid \$7.8 million to acquire service territory since 1990. Ex. 24 at 18. This payment included \$350,000 for the facilities that the displaced utility installed for service. *Id.* But after acquiring these areas, Rochester had to pay an

additional \$36 million in electrical infrastructure, excluding generation resources, to provide service to these areas. *Id.* Similarly, the City of Buffalo invested approximately \$2.3 million in distribution facilities for service territory acquired since 1988. *Id.*

For Rochester, the MPUC's approach understated the avoided costs of service by over one-hundred percent of the facilities costs, and nearly five times the loss-of-revenue award. Rather than put the displaced utility in a comparable position but for the service territory acquisition, the displaced utility has received a windfall. This Court, charged with reviewing the agency's decision, must consider this empirical evidence, part of the record in the present case, that the MPUC's approach woefully understated the costs that the displaced utility has avoided. Its application of section 216B.44 was fundamentally flawed.

#### **B. AVOIDED SYSTEM IMPROVEMENT COSTS.**

The MPUC incorrectly concluded that GRPUC was simply re-arguing past positions concerning an "averaging/allocation" approach. The Order expressed a preference for the "incremental" approach as providing "greater accuracy due to its tight focus on the specific situation of the displaced utility." R.App. 160. The MPUC mischaracterized GRPUC's approach as "averaging and allocating system-wide costs" and in "allocating costs" based upon the 2000 rate study. *Id.* at 159. Instead, GRPUC's approach was based on the actual cost of LCP facilities in and surrounding the Annexed Areas, not an average or allocation of system-wide costs. GRPUC did **not** rely upon the 2000 rate study costs to calculate avoidable system improvements. Exhibit DAB-1 at 14. The only data used from the rate study were estimates of peak demand and monthly consumption, not cost allocations. *Id.*

GRPUC instead followed the Commission's incremental approach, narrowly determining, albeit in a more accurate and close-fitting fashion, LCP's specific avoided costs. The pre-filed testimony specifically explained GRPUC's approach to avoided capital costs, including system savings. Ex. 22 at 13-15; Ex. 23 at 39. This approach recognized the reality that LCP's backbone system capacity and substation capacity can be used to serve other customers if they are not being used to serve the existing customers in the Acquisition Areas. The *Buffalo* decision did not address the benefit of freed-up capacity, instead focusing upon the specific facts at issue, including Wright-Hennepin's arguments that the new substation and other backbone facilities would be required with or without the affected areas, due to its rapid growth. *Buffalo*, Add. 22, at opinion page 7.

Contrary to the MPUC's claim that GRPUC invented the savings to LCP, GRPUC's analysis was supported by the record. Ex. 23 at 38-40; Ex. 24 at 17-18. By contrast, although LCP claimed in its exceptions that it "has more than adequate capacity on its system," it failed to provide any citation whatsoever to the record. R. App. at 44. GRPUC also specifically determined the benefits of freed-up capacity by LCP not serving the Annexed Areas. T. at 257-58. LCP's own witness provided support for GRPUC's view that freed-up capacity for substations benefits the existing substations. T. at 140, 147. The record supported GRPUC's analysis.

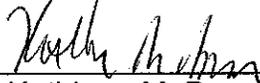
The MPUC erred in failing to recognize the true costs that LCP will avoid from GRPUC's acquiring the Annexed Areas.

**CONCLUSION**

For the reasons above-stated, the Court of Appeals should reverse the MPUC's order and reinstate the Administrative Law Judge's decision.

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The appendix to this brief is not available for online viewing as specified in the *Minnesota Rules of Public Access to the Records of the Judicial Branch*, Rule 8, Subd. 2(e)(2) (with amendments effective July 1, 2007).