

NO. A05-2550

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 by Lake Country Power

Grand Rapids Public Utilities Commission,

Relator,

vs.

Minnesota Public Utilities Commission,
Lake Country Power,

Respondents.

**REPLY BRIEF OF RELATOR
GRAND RAPIDS PUBLIC UTILITIES COMMISSION**

McGRANN SHEA ANDERSON CARNIVAL
STRAUGHN & LAMB, CHARTERED
Kathleen M. Brennan (#256870)
Andrew J. Shea (#99909)
800 Nicollet Mall, Suite 2600
Minneapolis, MN 55402-7035
(612) 338-2525

*Attorneys for Relator
Grand Rapids Public Utilities Commission*

FELHABER, LARSON, FENLON
& VOGT, P.A.
Harold LeVander, Jr. (#62509)
444 Cedar Street, Suite 2100
St. Paul, MN 55101-2136
(651) 312-6005

*Attorneys for Respondent
Lake Country Power*

STATE OF MINNESOTA
Kari Valley Zipko (#330413)
Assistant Attorney General
Office of Attorney General
445 Minnesota Street, Suite 1100
St. Paul, MN 55101
(651) 282-5700

*Attorneys for Respondent
Minnesota Public Utilities Commission*

Filed: October 2, 2006

TABLE OF CONTENTS

	<u>Page</u>
Table of Authorities.....	ii
Summary of the Argument.....	1
Argument	2
I. The MPUC Award, Without Any Reasonableness Check, Was Unconstitutional, Arbitrary, And Capricious.....	2
A. The Award Was Unconstitutional.	2
B. The Award Was Arbitrary And Capricious.....	4
C. The MPUC Improperly Overruled ALJ Credibility Findings	8
D. The MPUC's Order Inverted the Law	9
II. The MPUC Erred In Determining Avoidable Power Costs.	10
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.....	12
Conclusion	14

TABLE OF AUTHORITIES

<u>Statutes</u>	Page
Minn. Stat. § 14.60, Subd 4	6
Minn. Stat. § 216B.44	passim
Minn. Stat. § 645.17	3
 <u>Cases</u>	
<i>Denny v. Minneapolis American Indian Center</i> , 524 N.W.2d 474, 477-78 (Minn. App. 1994)	9
<i>Flanagan v. Lindberg</i> , 404 N.W.2d 799, 800 (Minn. 1987)	3
<i>Helvering v. Hammel</i> , 311 U.S. 504, 510-11 (1941)	10-11
<i>In re Application of City of Buffalo</i> , Ct. App. No. A05-1410 (Minn. App. 2006) ..	7, 8, 9, 10
<i>In re Excess Surplus of Blue Cross and Blue Shield</i> , 624 N.W.2d 264, 275 (Minn. 2001)	9
<i>In re Northern States Power Gas Utility</i> , 519 N.W.2d 921, 925 (Minn. App. 1994) (citing <i>In re Space Center Transp.</i> , 444 N.W.2d 575, 581 (Minn. App. 1989)	5, 12
<i>Peoples Natural Gas v. Minnesota Pub. Util. Comm'n</i> , 342 N.W.2d 348, 353 (Minn. App. 1983), <i>rev. denied</i> (Minn. Apr. 24, 1984)	11
<i>State Farm Mut. Auto. Ins. Co. v. Campbell</i> , 538 U.S. 408, 426 (2003)	3
 <u>Administrative Decisions</u>	
<i>In re Application of City of Olivia</i> , MPUC No. E-288, 136/SA-85-93, Order Setting Compensation for Service Extension, 17 (June 27, 1986).....	3, 8

SUMMARY OF THE ARGUMENT

In response to GRPUC's constitutional and legal challenges, the MPUC and LCP have simply repeated the order of the MPUC. But the failings of the order are at issue in the present case. Repeating the order is not a substitute for judicial review. This Court must review the legal issues of whether the award was unconstitutional, whether the whether the MPUC erred in applying section 216B 44 to determine the "appropriate value", to determine loss of revenue, and to determine avoidable expenses. Although some deference may be due an agency as to technical issues, constitutional issues are not within the expertise of the MPUC.

Because the MPUC imposed the highest electric service territory award in Minnesota history without any reasonableness test, it has failed to discharge its duty under section 216B.44 to determine "appropriate value", and subjected GRPUC to an unconstitutional damages award. The MPUC order in no way explained how two seemingly ordinary residential subdivisions could generate such a remarkable award. The MPUC order in no way considered the caution and reasonableness tests proposed by the Department of Commerce, a neutral party. The MPUC order in no way considered the new evidence of the significant costs to serve an urban-density residential subdivision. And the MPUC order failed to consider its own past precedent of applying a reasonableness test.

The MPUC order was arbitrary and capricious in ignoring LCP's own assessment of its damages, significantly below that advocated by its expert witness. It was arbitrary and capricious in refusing all reasonableness checks to the final award. It was arbitrary and capricious and unsupported by the record in awarding compensation to the precise

area in which no party projected growth, an undeveloped area platted since 1952 without any customers.

Finally, the MPUC erred as a matter of law in determining “loss of revenue” under section 216B.44. The MPUC accepted the analysis of LCP’s expert witness in terms of vague oral testimony, but failed to consider his written, more specific, and higher, purchased power cost. The MPUC’s failure to distinguish between the expert’s position and the local knowledge of the client is telling. And the MPUC’s failure to consider true avoided system improvement costs constitutes legal error in determining loss of revenue.

ARGUMENT

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

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

Contrary to the MPUC’s arguments that no “statute, rule or case” requires a reasonableness measure, the express statutory charge of the agency requires the MPUC to consider what is appropriate. “[T]he commission shall fix and determine the appropriate value of the property within the annexed area. . . .” Minn. Stat. § 216B.44. Indeed, one of the express factors that the MPUC must consider is “other appropriate factors.” Minn. Stat. 216B.44. That the word “appropriate” is repeated in the statute is significant.

If the Legislature intended the Commission to determine an amount without any restriction, it could have stated that the MPUC must determine damages, or the impact upon the displaced utility, or limited the statutory criteria to monetary determinations. Instead, the very language of "appropriate value" requires the MPUC to consider what is "appropriate" under the specific facts and circumstances of the case, and to consider the "value" of the property taken, implying the objective and reasonable principles of valuation. Requiring a "reasonable" and "appropriate" award is hardly a novel approach. It is required by the statute.

Moreover, the MPUC is ultimately restricted by the Constitution. Due process requires a reasonable damages award *Flanagan v. Lindberg*, 404 N.W 2d 799, 800 (Minn. 1987); *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 426 (2003). And this Court must construe statutes to avoid an unconstitutional result. Minn. Stat. § 645.17. In the past, the MPUC itself has considered the reasonableness of its award. *In re Application of City of Olivia*, MPUC No. E-288, 136/SA-85-93, Order Setting Compensation for Service Extension, 17 (June 27, 1986) (Add 51). The suggestion that a reasonableness check was appropriate years ago but no longer is appropriate, when the awards are significantly higher, makes little sense. By failing to apply any reasonableness check to the final award, the MPUC acted contrary to the language of section 216B.44, contrary to its own past precedent, and the constitutional due process requirements.

The MPUC ignored the warnings of a neutral party, the Department of Commerce. R.App. 251; R.App. 254 (noting results in this case are 400 – 500% higher than average historical mill rate). The Department's witness also supplied past orders

and settlements as “a range of reasonable outcomes” and “a frame of reference for value by reasonable parties.” T. at 347:19 - 348:1-5. This analysis was one of four reasonableness tests rejected by the MPUC

The MPUC’s citation to section 216B.41 is puzzling. That GRPUC is not required to acquire service territory does not diminish the constitutional requirement of reasonable damages. A plaintiff in a civil case cannot claim that a defendant’s recourse to bankruptcy protection allows for unreasonable damages award. Similarly, LCP’s reasoning that if the MPUC asked the right questions, the result is necessarily reasonable is at best a self-serving tautology. LCP Brief at 5. Perhaps LCP is simply rephrasing its expert’s opinion that the award has no limits: “Simply applied the same methodology . . . and we’ve come up with this number. . . .” T. at 115:10-13. An award is not reasonable simply because the decider declares it to be so. In any event, the MPUC in the present case did not even consider if the award were reasonable, let alone an “appropriate value;” it simply issued the award. The constitution requires the agency to consider the reasonableness of the award

The MPUC’s failure to consider the “appropriate value” and any reasonableness check to the award violated section 216B.44, as well as the City’s due process rights to reasonable damages.

B. THE AWARD WAS ARBITRARY AND CAPRICIOUS.

Although in its brief the MPUC has elaborated upon the reasoning of its order, the order itself reflects agency whim. The MPUC “offered an explanation that is contrary to the evidence” and “entirely failed to consider an important part of the

problem.” *In re Northern States Power Gas Utility*, 519 N.W 2d 921, 925 (Minn. App. 1994) (citing *In re Space Center Transp.*, 444 N.W.2d 575, 581 (Minn. App. 1989)).

First, the MPUC relied upon facts not in evidence to support its conclusion. The MPUC stated that the load factor data for purchased power costs was not available. R.App. 162. But the evidence instead revealed that LCP’s expert did not ask and did not know if the data were available. T. at 49:16-23. This issue is significant, as the MPUC order started by criticizing GRPUC’s use of the 2000 rate study, rather than criticizing LCP – which bears the burden of proof – for not seeking or using class-specific power cost data. The MPUC credited LCP - the party - with “first-hand knowledge of its load characteristics,” although the utility did not present any fact witnesses. R.App. 162. Instead, LCP presented only expert testimony. It is axiomatic that an expert witness may offer an expert opinion, but the expert cannot be interchanged for the party. LCP’s expert, by contrast, provided only vague testimony concerning load and rates. T. at 52:19 – 53:20.

The MPUC also assumed, without any support in the record, that increased costs justified LCP’s higher retail rates. R.App. 138 (Transcript page 81) To be sure, the record revealed that LCP had increased its rates T. at 305. But it was also undisputed that the “expired” charges justified charging the customers in the Annexed Areas perhaps the highest retail electric rates in the state. 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). Similarly, the 2000 rate study specified certain charges to these customers to justify their higher rates. T. at 217-18. The record also revealed losses due to subsidiary investments. T. at 337. All of which signifies that the assumption that certain

costs required LCP to increase rates for these customers is highly suspect, and unsupported by the record.

The MPUC also assumed, without any citation in the record, that “serving areas with higher population densities is normally less expensive than” serving less dense areas. R.App. 154. GRPUC provided task force findings explicitly refuting this contention. R.App. at 200. The MPUC also assumed, without any citation in the record, that a contribution-in-aid-of-construction policy (or a line extension policy) charging new customers an additional fee was a “common practice for all Minnesota utilities” and that “nearly all other Minnesota utilities” use one. R.App. 157. The MPUC may not take judicial notice without providing the parties with an opportunity to respond. Minn. Stat. § 14.60, subd. 4. The MPUC’s reasoning in these instances, without any support in the record, undermines its over arching analysis purporting to rely upon its technical expertise.

The MPUC also failed to consider evidence in the record as to future customers. The record revealed that LCP’s expert projected future customers in certain areas, and that GRPUC’s community development director cautioned that those estimates were optimistic. Ex. 20 at 7-8. But no evidence in the record supported future customers in the undeveloped area that was platted since 1952 without customers. R.App. 155; T. at 251; Ex. 24 at 6; Ex. 20 at 2-3. Although both the MPUC and LCP argue that if no customers arrive, GRPUC need not pay, they fail to explain that the projected rate of growth, the timing of when future customers arrive, affects the mill rate that GRPUC must pay.¹ Ex. 1 (DRE-9) at 1 (reflecting loss of revenue per year, with net loss of

¹ They also fail to explain that the mill rate itself, regardless of the ultimate number of future customers, can be unreasonable or punitive.

revenue changing significantly based upon when new customers are added as usage) Certainly it is not a “radical departure” from precedent to consider the specific facts of the case. In this case, the MPUC awarded LCP for areas in which no record evidence supported future customers.

Second, the MPUC entirely failed to consider an important part of the problem. The MPUC failed to consider any reasonableness test to the final award. As noted above, this position is contrary to the statutory demand that the MPUC determine “appropriate value” of the property at issue. Minn. Stat. § 216B.44. And it is contrary to the constitutional prohibitions of reasonable damages. Citing to the use of a methodology in other cases does nothing to demonstrate that it was correctly applied, or represented a reasonable amount of damages, as to the particular facts of the present case.

Although LCP has argued that a reasonableness test would somehow create a chilling effect upon settlement discussions, the reverse is true. The lack of a reasonableness test has stalled reasonable settlement discussions throughout the state. See, e.g., Request of the City of Rochester for Leave to File Brief as Amicus Curiae (July 14, 2006), *In re Application of City of Buffalo*, Ct. App. No. A05-1410, at 3 (Minn. App. 2006), (“For example, in an ongoing attempt to negotiate with the adjacent rural electric cooperative, Rochester has been told that *Buffalo* is “settled law” and that the going price is 32 mills. This position fails to analyze and properly apply the law to the specific facts of the case, yet is has been cited throughout the state.”); Request of the City of Moorhead for Leave to File Brief as Amicus Curiae (July 13, 2006), *In re Application of City of Buffalo*, Ct. App. No. A05-1410, at 2, (noting current service

territory agreement of 7.75 mills/kWh and explaining “[a]s a result of the decision by the MPUC in this case [in *Buffalo*], however, negotiations have been extremely difficult. While Moorhead believes that the decision in the City of Buffalo case does not control all service territory compensation cases, the practical effect has been that utilities rely upon the decision to extract exorbitant payments for a claimed loss of future revenues.”). The MPUC rejected out of hand all of four reasonableness tests. It even rejected LCP’s determination that the “current formula” produced 8 mills for future customers. Ex. 28. It failed to consider any reasonableness test to check its analysis.² This absolute refusal to consider any bound of reasonableness constitutes arbitrary and capricious action.

C. THE MPUC IMPROPERLY OVERRULED ALJ CREDIBILITY FINDINGS.

The MPUC criticized the ALJ Report and Recommendation in this matter as deficient in terms of factual findings and analysis. But a fair review of the report reflects that the ALJ provided thoughtful consideration to the disputed issues, based upon the specific facts in this case, and proposed two alternatives for the MPUC to consider. The entire reason for the alternative was the failure of the formula, unexplained by the experts, that created the highest award in Minnesota history. Add. at 13. And the distinguishing factor in the present case, with so many existing customers, was that there was no need to create a model to estimate potential customers. *Id.* Actual customer data should govern. *Id.*

² It bears noting that one of the reasonableness tests rejected by the MPUC, concerning the margin at issue, is based upon the MPUC’s position that the margin or equity of a rural electric cooperative differs from other utilities. MPUC Brief at 41. But the MPUC has in the past held that the nature of a displaced utility – whatever the type of corporate structure – cannot be used to distort the award. *In re Application of City of Olivia*, MPUC No. E-288, 136/SA-85-93, at 12-13 Order Setting Compensation for Service Extension (June 27, 1986) (Add. 46-47).

Contrary to claims that the ALJ Report contained few factual findings, the report detailed the positions of each party (Add. 9-11), noted the distinguishing factor of a significant number of existing customers with very few projected future customers (Add. 12-13), considered the reasonableness of the parties' positions (Add. 11-12, 13-14), and determined that LCP's award was unreasonable. Add 14

Although an agency may reach a different conclusion than an administrative law judge, the agency must clearly explain the difference, grounded in the record, and witness credibility determinations must not be lightly set aside. *Denny v. Minneapolis American Indian Center*, 524 N.W.2d 474, 477-78 (Minn.App 1994).

In the *In re Excess Surplus of Blue Cross and Blue Shield* case, the agency reacted to biased findings by the administrative law judge 624 N.W.2d 264, 275 (Minn 2001) (noting the agency "inserted a more precise statement or modified the tone from unquestioning applause of BCBSM's plan to neutrality" in addition to reaching a different result). No such concern appeared in the present case. The ALJ Report considered both parties' positions, and although finding in favor of GRPUC's findings of costs, Add. 14, it also presented an alternative option of a gross revenue multiplier, which was comparable, but higher than, the results proposed by GRPUC. Add. 15-16.

The MPUC order in the instant case appears to rely more heavily upon the MPUC order in another, separate proceeding, the *Buffalo/Wright-Hennepin* electric service territory matter, than upon the factual evidence in the record. Those failings, combined with the statements of two of the four Commissioners against the law of a

city's acquiring electric service territory, undermine the agency's rejecting of the ALJ's analysis.³

The MPUC acted arbitrarily in summarily rejecting the ALJ's determinations of witness credibility.

D. THE MPUC'S ORDER INVERTED THE LAW.

LCP and the MPUC apparently disregarded the irony that the order will discourage very purpose of the statute at issue: the ability of a municipal utility to grow with its city. 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").

By refusing to consider any reasonableness test on the award, the MPUC order signaled that reasonableness has no place in electric service territory awards. The recent order as to existing customers in the *City of Buffalo* case has already dramatically affected settlement positions throughout the state. See *infra* p. 7. The order entirely failed to comment upon, let alone criticize, 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, all clearly contrary to the purposes of Section 216B.44. By failing to consider any test, the MPUC has effectively thwarted the statutory rights of municipal utilities. See *Helvering v. Hammel*, 311 U.S. 504, 510-11 (1941) (courts may limit

³ The MPUC suggestion that Commissioner Johnson suggested "taking back" his vote due to the oral calculations is not supported by the entirety of the transcript, which includes his comments against the "forced sale" allowed by statute (R. App. 142), his desire to adopt the cooperative's number (*Id.*), his support of the motion to adopt LCP's proposed award without any change (R.App. 141), and his lobbying fellow Commissioners to increase the number of the final award (R.App. 143)

statute if literal approach “would lead to absurd results or would thwart the obvious purpose of the statute.”).

The MPUC’s Order has the result of unduly burdening cities exercising their statutory rights – contrary to plain language of the law allowing municipalities to grow with their cities. Instead, the Order results in compensation awards with no check on reasonableness. The MPUC Order was arbitrary and capricious in inverting the purposes of the law.

II. THE MPUC ERRED IN DETERMINING AVOIDABLE POWER COSTS.

The MPUC departed from its past precedent in determining avoidable power costs in the present case. “An agency must either conform to its prior norms and decisions or explain the reason for its departure from such precedent.” *Peoples Natural Gas v. Minnesota Pub. Util. Comm’n*, 342 N.W.2d 348, 353 (Minn. App. 1983), *rev denied* (Minn. Apr. 24, 1984). Neither the MPUC nor LCP has cited any authority of using a system-wide average to determine wholesale power costs. GRPUC has provided authority against such an approach. Initial Brief at 33-34. The MPUC failed to consider that LCP’s approach in this case was contrary to past precedent. Instead, the MPUC faulted GRPUC for using a 2000 rate study, the best information available as to power costs by class for the Annexed Areas.

Although the MPUC has characterized its decision as carefully determining purchased power based upon the record, without accepting either party’s position, the MPUC instead adopted LCP’s expert’s approach, and decreased it by five mills. R. App. 141-2 (T. at 93-94); R.App. 162. The MPUC ignored and misstated evidence in the record that LCP’s expert failed to ask for or consider data specific to the Annexed

Areas. T. at 49:16 – 23. The MPUC ignored evidence in the record that the 2000 rate study was used to justify perhaps the highest electric rates in the state for the Annexed Areas. T. at 217:14-15; 217:21 – 218:6; 218:22-25; 228:5-10. The MPUC ignored and misstated evidence in the record of the mystery of why LCP continued to increase its rates even as its costs were decreasing. T. at 52:19 – 53:20; T. 124. The fact remains that higher rates justified further rate increases to Annexed Area customers, which increased the final award. The MPUC misstated the record by crediting LCP's knowledge of its own load factors, as opposed to the expert witness who testified in lieu of any factual witness. R.App. 162. And the MPUC failed to consider LCP's calculation of wholesale power costs that would decrease its award by eight mills. R App. 40.

The MPUC's arguments based upon a rate case are inapplicable. First, as noted above, the MPUC did not independently determine load factor based upon the evidence in the record. In any event, the case cited by the MPUC is distinguishable, as the MPUC in that case considered a separate statutory provision concerning rate cases. A rate case requires a balancing of the interests of the utility's investors, who seek a reasonable rate of return, with the interests of the ratepayers, who seek to pay reasonable rates. *In re Northern States Power*, 519 N.W.2d at 924. This Court has held that in such circumstances, the MPUC may consider a return on equity not advanced by any expert witness, but supported by the record. *Id.* at 926. Even so, the Court criticized the MPUC for failing to cite the specific evidence relied upon or providing "[a] more detailed weighing of the conflicting evidence," although it affirmed the decision. *Id.* at 926. In the present case, by contrast, the MPUC was charged to determine LCP's damages. It did so by unconditionally adopting LCP's expert's system-

wide average approach, contrary to precedent, and by ignoring or misstating evidence in the record. LCP bears the burden of proof, and any information lacking in the record must be assigned against it. Rather than taking this position, the MPUC complimented LCP for its application of the formula. R App. 162.

Moreover, the MPUC's arguments at best vacillate between a system-wide approach and an incremental approach. Allowing a system-wide analysis for power costs should promote the system costs of all other expenses – including operation and maintenance costs, administration, interest, depreciation. As the order stands, the displaced utility's expenses are minimized by confining them to "incremental" charges. Such an approach is erroneous as a matter of law and arbitrary and capricious.

The MPUC erred in relying upon LCP expert'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.

The MPUC rejected GRPUC's approach to avoidable expenses without considering the benefits that LCP will enjoy. LCP will benefit from freed-up capacity that it may use for other customers. Ex. 22 at 13-15; Ex. 23 at 38-40; Ex. 24 at 17-18. LCP's own witness provided support for GRPUC's view that freed-up capacity for substations benefits the existing substations. T. at 140, 147. GRPUC specifically determined the benefits of freed-up capacity by LCP not serving the specific Annexed Areas. T. at 257-58. Its approach cannot properly be described as an allocated or system average.

Although LCP has argued that it “already has more capacity than it needs,” that argument is not supported by the record. LCP Brief at 9. Nor did the MPUC consider the true avoided costs. The danger of the incremental approach, as clearly portrayed by the City of Rochester and the City of Buffalo, understates avoidable expenses. Ex. 24 at 18. Rather than put the displaced utility in a comparable position but for the service territory acquisition, the displaced utility has received a windfall. And the MPUC’s failure to consider any reasonableness test alarmingly reinforced the windfall

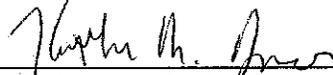
The MPUC erred in failing to recognize the true costs that LCP will avoid from GRPUC’s acquiring the Annexed Areas.

CONCLUSION

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

Dated: October 2, 2006.

McGRANN SHEA ANDERSON CARNIVAL
STRAUGHN & LAMB, CHARTERED

By : 
Kathleen M. Brennan #256870
Andrew J. Shea #99909

800 Nicollet Mall, Suite 2600
Minneapolis, MN 55402
Telephone: (612) 338-2525
Fax: (612) 339-2386

*Attorneys for Relator Grand Rapids Public
Utilities Commission*