

No. A05-2550

STATE OF MINNESOTA

IN COURT OF APPEALS

In the Matter of the Application of 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.

**RESPONSE BRIEF AND ADDENDUM OF
RESPONDENT MINNESOTA PUBLIC UTILITIES COMMISSION**

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LEGAL ISSUES

I. IS THE MINNESOTA PUBLIC UTILITIES COMMISSION DETERMINATION OF APPROPRIATE COMPENSATION SUPPORTED BY SUBSTANTIAL EVIDENCE IN THE RECORD?

Decision of the Minnesota Public Utilities Commission: The Minnesota Public Utilities Commission ruled in the affirmative.

Apposite Authority:

In re Excess Surplus Status of Blue Cross & Blue Shield of Minn., 624 N.W.2d 264 (Minn. 2001)

In re Complaint Regarding the Annexation of a Portion of the Serv. Territory of People's Coop. Power Ass'n by City of Rochester (North Park Additions), 470 N.W.2d 525 (Minn. Ct. App. 1991), *rev. den.* (July 24, 1991)

In re Petition of Northern States Power Co. for Authority to Change its Schedule of Rates for Elec. Serv. in Minnesota, 416 N.W.2d 719 (Minn. 1987)

II. IS THE MINNESOTA PUBLIC UTILITIES COMMISSION DETERMINATION OF APPROPRIATE COMPENSATION ARBITRARY AND CAPRICIOUS?

Decision of the Minnesota Public Utilities Commission: The Minnesota Public Utilities Commission ruled in the negative.

Apposite Authority:

In re Excess Surplus Status of Blue Cross & Blue Shield of Minn., 624 N.W.2d 264 (Minn. 2001)

In re Detailing Criteria and Standards for Measuring an Electric Utility's Good Faith Efforts in Meeting the Renewable Energy Objectives Under Minn. Stat. § 216B.1691, 700 N.W.2d 533 (Minn. Ct. App. 2005), *aff'd,* 714 N.W.2d 426 (Minn. 2006)

In re Complaint Regarding the Annexation of a Portion of the Serv. Territory of People's Coop. Power Ass'n by City of Rochester (North Park Additions), 470 N.W.2d 525 (Minn. Ct. App. 1991), *rev. den.* (July 24, 1991)

III. IS THE DECISION OF THE MINNESOTA PUBLIC UTILITIES COMMISSION UNCONSTITUTIONAL?

Decision of the Minnesota Public Utilities Commission: The Minnesota Public Utilities Commission did not rule.

Apposite Authority:

Minn. Stat. § 216B.37 (2005)

Minn. Stat. § 216B.40 (2005)

Minn. Stat. § 216B.41 (2005)

Minn. Stat. § 216B.44 (2005)

In re Complaint Regarding the Annexation of a Portion of the Serv. Territory of People's Coop. Power Ass'n by City of Rochester (North Park Additions), 470 N.W.2d 525 (Minn. Ct. App. 1991), rev. den. (July 24, 1991)

STATEMENT OF THE CASE

Minnesota Statutes section 216B.44 (a) (2005) allows a municipal utility that either extends its corporate boundaries through annexation or consolidation, or that determines to extend its service territory within its existing corporate boundaries, to petition the Minnesota Public Utilities Commission (“Commission”) to furnish electric service to the area. If the municipal utility and displaced utility are unable to agree as to the terms of payment or exchange, either party may petition the Commission to determine the appropriate compensation. Minn. Stat. § 216B.44 (b) (2005). Minnesota Statutes section 216B.44 (b) (2005) requires that, in determining appropriate compensation, the Commission is to consider the original cost of the property, less depreciation, loss of revenue to the utility formerly serving the area, expenses resulting from integration of facilities, and other appropriate factors.

Relator Grand Rapids Public Utilities Commission (“Relator”) petitioned the Commission to transfer service territory and determine compensation. The Commission referred the matter of compensation to the Office of Administrative Hearings (“OAH”) for a contested case. The Administrative Law Judge (“ALJ”) found Relator’s proposed compensation figures more reasonable and recommended the Commission adopt Relator’s proposed compensation award. The Commission accepted in part and rejected in part the ALJ’s report. First, the Commission rejected the ALJ’s two-step method for determining whether an area was already receiving electric service within the meaning of the statute to allow compensation for future customers to Respondent Lake Country Power (“Lake Country” or “Cooperative”), finding that the two-step method applied is

contrary to the requirements of the statute and precedent established by the Commission and this Court. The Commission awarded lost revenues for future customers on the basis that the area was receiving service within the meaning of the statute. Further, the Commission found that both parties projected some customers to locate in the areas and that Lake Country was entitled to lost revenues for those future customers that did, in fact, locate in the areas.

The primary item in dispute in this case, however, is the amount of lost revenue to be paid to the displaced utility. By awarding compensation that includes lost revenue, the Commission attempts to put the displaced utility in the same position it would have been but for the acquisition. Because the loss of service area to the displaced utility does not result in an immediate and corresponding reduction in the utility's cost of service, the Commission attempts to protect the displaced utility's remaining customers from paying higher rates to recover fixed costs that would have been recovered through charges to customers in the lost areas. Overhead and administrative expenses, as well as taxes, depreciation and maintenance, among others, are all costs that continue to be incurred. The loss of sales to the annexed areas means there are fewer customers left to share the burden of these fixed costs.

The Commission applies a net revenue loss formula to determine lost revenue for a displaced utility. In the instant matter, the Commission declined to accept the ALJ's findings and conclusions that the net revenue loss formula is no longer appropriate for calculating lost revenues. The Commission reviewed the evidence in the record and found that it did not support the ALJ's finding. Further, the Commission rejected the

ALJ's findings on avoided costs. The Commission found that, consistent with precedent and contrary to the assertions of Relator, avoided costs should be calculated incrementally and not on an allocated basis. The Commission also rejected the inclusion in avoided costs of some items that were, in fact, not avoided. The Commission noted that the ALJ made no specific findings on many of these issues, but the ALJ's adoption of Relator's proposed compensation award appeared to incorporate Relator's assessment of avoided costs.

Moreover, based on the evidence in the record, the Commission found that neither Relator's nor Lake Country's assessment of avoided purchased power costs was accurate. The Commission found that the evidence supported a reasonable cost of purchased power at a point between the two parties' proposed amounts. Because neither party's avoided cost figure for purchased power costs was correct, the Commission examined the record as a whole and applied its expertise in calculating compensation for service territory acquisitions to make the most accurate determination possible. The Commission ultimately found that a total compensation rate of 30 mills/kWh applicable to both existing and future customers was the appropriate compensation to be paid to Lake Country under the statute.

Finally, the Commission rejected the ALJ's proposed "reasonableness" tests. These "reasonableness" tests did not reflect the application of the factors for determining compensation outlined by the statute and, therefore, were not appropriate measures to determine compensation in this case.

STATEMENT OF FACTS

I. LEGAL AUTHORITY

In 1974, the Minnesota Legislature determined that the orderly development of economical statewide electric service required granting electric utilities exclusive service rights within designated service areas. Minn. Stat. § 216B.37 (2005). The Legislature further provided that “each electric utility shall have the exclusive right to provide electric service at retail to each and every present and future customer in its assigned service area. . . .” Minn. Stat. § 216B.40 (2005).

In recognition that service areas may require adjustment over time, however, the Legislature established a procedure to allow municipal utilities to acquire parts of another utility’s service territory. Minn. Stat. § 216B.44 (2005). Section 216B.44 (a) (2005) provides, in part:

whenever a municipality which owns and operates an electric utility (1) extends its corporate boundaries through annexation or consolidation, or (2) determines to extend its service territory within its existing corporate boundaries, the municipality shall thereafter furnish electric service to these areas *unless the area is already receiving electric service* from an electric utility, in which event, the municipality may purchase the facilities of the electric utility serving the area.

(emphasis added). Since 1989, the Commission has held that an area is “already receiving electric service” if the assigned utility has facilities in place capable of meeting the area’s needs while compensation issues are being resolved.¹

¹ See, *inter alia*, *In re Complaint by Kandiyohi Cooperative Elec. Power Ass’n Against Willmar Municipal Util. Comm’n for Extending Elec. Facilities in and Adjacent to* (Footnote Continued on Next Page)

Service territory transfers are not automatic upon annexation, however. The Legislature established that after April 12, 1974, unless a municipality which owns and operates an electric utility elects to purchase the facilities and property of the other electric utility as provided in section 216B.44, “the inclusion by incorporation, consolidation, or annexation of any part of the assigned service area of an electric utility within the boundaries of any municipality shall not in any respect impair or affect the rights of the electric utility to continue and extend electric service at retail throughout any part of its assigned service area.” Minn. Stat. § 216B.41 (2005).

When a municipality which owns and operates an electric utility intends to acquire another utility’s service territory, Minn. Stat. § 216B.44 (2005) specifically outlines a procedure to transfer the service area and what factors are to determine appropriate compensation. Section 216B.44 (b) provides that the parties may request that the Commission determine the appropriate terms for exchange or sale. In making its

(Footnote Continued From Previous Page)

Westwind Estates, E-118, 329/SA-89-502, Order Denying Reconsideration on the Merits and Accepting Amended Answer (October 19, 1989), *aff’d*, 455 N.W. 2d 102 (Minn. Ct. App. 1990) (“*Kandiyohi*”); *In re Complaint Regarding the Annexation of a Portion of the Service Territory of People’s Coop. Power Ass’n by City of Rochester (North Park Additions)*, E-132,299/SA-88-270, Order Determining Compensation (July 11, 1990), *aff’d*, 470 N.W.2d 525 (Minn. Ct. App. 1991) (“*North Park*”), *rev. den.* (July 24, 1991); *In re Application by City of Rochester for an Adjustment of its Service Area Boundaries with People’s Coop. Power Ass’n, Inc.*, E-299,132/SA-93-498, Order Determining Compensation and Denying Motion to Dismiss (November 30, 1995) (“*Rochester Order Determining Compensation*”), *aff’d*, 556 N.W.2d 611 (Minn. Ct. App. 1996) (“*Rochester*”), *rev. den.* (Feb. 26, 1997); *In re Application of City of Buffalo to Extend its Assigned Service Area into the Area Presently Assigned to Wright-Hennepin Coop. Elec. Ass’n*, E221, 148/SA-03-989, (“*City of Buffalo*”), Order Determining Compensation and Requiring Compliance Filing (April 1, 2005) (“*City of Buffalo Order*”), *aff’d*, 2006 WL 1229596 (Minn. Ct. App.), *rev. den.* (July 19, 2006).

determination, the Commission is to consider “the original cost of the property, less depreciation, loss of revenue to the utility formerly serving the area, expenses resulting from integration of facilities, and other appropriate factors.” Minn. Stat. § 216B.44 (b) (2005).

II. PROCEDURAL HISTORY

Pursuant to Minn. Stat. § 216B.44, on June 12, 2003, Relator filed a petition with the Commission to extend its assigned service area into the service territory of Lake Country and asked the Commission to determine appropriate compensation to be paid to Lake Country for service rights to the acquired areas. Administrative Record Item No. 1.² The Commission referred the matter of compensation to the OAH for a contested case proceeding on October 16, 2003. R. 8. The ALJ issued his *Findings of Fact, Conclusions and Recommended Order (“ALJ Report”)* on January 3, 2005. Rel. App. 10. The case came back before the Commission for final determination on August 4, 2005. Rel. App. 118.

Relator and Lake Country had reached agreement on compensation for all loss factors except lost revenues. Rel. App. 18 ¶ 28. Relator advocated a total award for lost revenues of \$204,402, or 16.5 mills/kWh for existing customers only. Rel. App. 148. Lake Country advocated a total award of \$521,657, or 35.4 mills/kWh for existing customers and 32.4 mills/kWh for future customers. Rel. App. 148. The disparity between the two figures was largely due to differences in the parties’ calculations of

² Items from the administrative record will hereafter be referred to as “R. ____.”

avoided costs, or costs Lake Country would avoid by not having to serve the areas at issue. R. 17, Eicher Direct at 23, Exh. DRE-6 at 2; R. 23, Eicher Surrebuttal Exh. DRE-6R2 at 2, 5; R. 25 at 253-258; R. 22, Berg Surrebuttal Exh. DAB-1 at 2. Additionally, the parties disagreed regarding how many, if any, future customers should be counted in estimating future gross revenues from the areas and whether lost revenues for future customers should be included in the compensation award. Rel. App. 16-17 ¶ 20 and ¶ 25. The ALJ recommended adopting Relator's figures using the net revenue calculation or the gross revenue multiplier formula, and that Lake Country not be awarded lost revenue for future customers. Rel. App. 25-26.

The Commission accepted in part and rejected in part the *ALJ Report*. First, the Commission reviewed the evidence in the record and found that it did not support the ALJ's finding. The Commission noted that the *ALJ Report* contained few findings of fact, did not systematically apply the net revenue loss compensation formula to either party's version of the facts, and did not analyze the accuracy of either party's formula inputs. Rel. App. 150.

III. CONTESTED COST ISSUES

A. Avoided Costs

The most significant issue in dispute in this case is the determination of avoided costs. The disparity in the parties' positions on lost revenue was due almost entirely to differences in how the parties calculated avoided costs. Rel. App. 148. The ALJ found that Relator's proposed compensation award was more accurate and recommended its adoption. Rel. App. 23. The Commission rejected the ALJ's findings on avoided costs,

finding that the ALJ made no specific findings on many of these issues, but the ALJ's adoption of Relator's proposed compensation award appeared to incorporate Relator's assessment of avoided costs. Rel. App. 158.

The Commission noted that the avoided cost dispute was comprised of four contested sub-issues: (1) whether avoided costs should be determined on an allocated or incremental basis; (2) whether it was reasonable to treat costs no longer incurred but reflected in a 2000 cost of service study as part of the cost of serving the annexed areas; (3) whether loss of service rights permitted the Cooperative to realize cost savings by postponing or cancelling system improvements or upgrades; and (4) whether it was reasonable to use the system-average cost of purchased power in calculating avoided purchased power costs or whether the number should be adjusted to reflect the load factor of the annexed areas and the effect of that load factor on purchased power costs. Rel. App. 158. The only finding in the ALJ's Report on these four issues is Finding 36, in which the ALJ generally approved of the use of allocated cost figures from the 2000 ratemaking study in determining avoided costs. Rel. App. 20 ¶ 36; Rel. App. 158. The Commission declined to accept that finding. Rel. App. 158.

First, the Commission rejected Relator's claim that avoided costs should be determined on the basis of allocations in the Cooperative's 2000 rate study or any other allocated basis. Rel. App. 160. The 2000 rate study identified the costs of supplying electricity to the Cooperative's general body of ratepayers at that time and allocated those costs to different customer classes on the basis of cost-of-service and other rate-design

principles. Rel. App. 159. The Commission found that the per-customer cost figures were not a reliable guide to determining avoided costs in this case. Rel. App. 159.

The Commission found that allocating costs among classes of customers who are actually on the utility's system is fundamentally different from determining what costs a utility will avoid if it loses particular customers:

In the first case, costs are properly allocated to ensure that active customers bear their fair share of fixed costs. In the second case, costs must be calculated incrementally, since not all the fixed costs allocated to particular customers will go away with the departing customers. Instead, the fixed costs formerly borne by the departing customers must be spread over those remaining on the utility's system.

Rel. App. 159. The Commission noted it had recently addressed this issue in the *City of Buffalo* case and reaffirmed the continued validity of calculating avoided costs incrementally. Rel. App. 159-160; *City of Buffalo Order*, PUC Add. 8-9. The Commission has consistently found that the incremental approach offers greater accuracy due to its tight focus on the specific situation of the displaced utility and more closely approximates displaced utilities' actual losses. Rel. App. 160; *City of Buffalo Order*, PUC Add. 8-9; *North Park Order*, PUC Add. 23; *In re Petition by City of Rochester for Approval of an Adjustment of its Serv. Territory Boundaries with People's Coop. Serv., Inc. (Celestica Property)*, MPUC Docket No. E132, 299/SA-02-496, Order Determining Compensation (June 19, 2003) ("*Celestica Order*"), Rel. Add. 130. Therefore, the Commission determine that no allocation was appropriate. Rel. App. 160.

Second, the Commission determined that the avoided cost figure should not include costs that the Cooperative no longer incurs. Rel. App. 160. The 2000 rate study

included three significant costs that Lake Country no longer incurs: 1) a one-time special assessment of \$600,000 from Great River Energy (“GRE”); 2) a \$178,000 non-recurring surcharge from GRE; and 3) \$1.66 million in substation charges that Lake Country no longer incurs because it purchased the substation. Rel. App. 160; R. 20, Eicher Rebuttal Exh. DRE-10 at 3. Relator’s witness agreed that the charges no longer existed and that costs that do not exist cannot be avoided. R. 25 at 216 and 218. The Commission therefore excluded these costs in determining compensation. Rel. App. 160.

Third, the Commission declined to include in the avoided cost figure \$51,220 Relator argued was system investment Lake Country could avoid by not serving the annexed areas. Rel. App. 160; R. 62 at 12. The Commission found no support for this figure since the record indicated there were no Cooperative investments scheduled to occur during the ten-year compensation period. Rel. App. 161; R. 20, Seeling Rebuttal at 2 and 5; Rel. App. 14 ¶ 16.

Finally, based on the evidence in the record, the Commission found that neither Relator’s nor Lake Country’s assessment of avoided purchased power costs was accurate. Rel. App. 161. Rather, the evidence supported a reasonable cost of purchased power at a point between the two parties’ proposed amounts. Rel. App. 161. The Commission found that Relator’s proposed figure included costs that were not avoided and that it failed to adjust for the effects of rate differentials in the rate structure of Lake Country’s wholesale supplier. Rel. App. 161. The Commission also found that Lake Country’s proposed amount was based on inaccurate assumptions of the consumption characteristics of the acquired customers. Rel. App. 161.

Because neither party's avoided cost figure for purchased power costs was correct, the Commission examined the record as a whole and applied its expertise in calculating compensation for service territory acquisitions to make the most accurate determination possible. After weighing all the factors, the Commission set avoided purchased power costs at 51.0 mills/kWh. Rel. App. 162. This mill rate fell within the range of cost figures proposed by the parties. Rel. App. 162; R. 24 at 53:8-20. This mill rate was further supported by adjusting the mill rate proposed by Relator for the anomalies resulting from Relator's use of the 2000 ratemaking study and its failure to recognize the effects of the off-peak discount granted to Lake Country by GRE. Rel. App. 162; R. 60 at 12. Further, by incorporating this mill rate into the total avoided cost equation, the Commission found that a total compensation rate of 30 mills/kWh applicable to both existing and future customers was the appropriate compensation to be paid to Lake Country under the statute. Rel. App. 162

B. No Indication of Manipulation of Formula.

In making its determination, the Commission declined to accept the ALJ's finding that policy changes by Minnesota cooperatives inflated compensation claims making the continued use of the net revenue loss formula suspect. Rel. App. 157. The ALJ supported his finding in a footnote, citing as an example the practice of not counting Contributions In Aid of Construction ("CIAC") among the costs that displaced utilities avoid by not serving annexed areas. Rel. App. 23 ¶ 47 n. 75. The ALJ stated that adjusting for CIAC under the net revenue loss formula was identified as a windfall to the cooperative by the ALJ in the *City of Buffalo* case. Rel. App. 23 ¶ 47 n. 75.

In the *City of Buffalo* case, the Commission declined to accept the ALJ's finding that CIAC should be included in avoided costs. *City of Buffalo Order*, PUC Add. 9-10. The Commission found that requiring CIAC is a common practice for all Minnesota utilities and that counting them as avoided would be inaccurate. *City of Buffalo Order*, PUC Add. 9-10. Cooperatives do not avoid a cost that they do not, in fact, incur. This Court agreed and affirmed the Commission's decision to exclude CIAC. Rel. Add. 28. As the Commission noted in the *City of Buffalo*, CIAC

are not a unique device contrived to drive up compensation for service territory acquisitions. Nearly all (if not all) Minnesota utilities have fees similar to those in this case. They are a reasonable and equitable means of apportioning between new and existing customers the cost of extending the system to new locations. They promote rate stability without causing hardship to individual customers or barriers to the provision of reliable and affordable statewide electric service.

Rel. App. 157 (citing *City of Buffalo Order*, PUC Add. 9). In this case, the Cooperative's witness testified that most utilities today have a line extension policy that requires a developer or customer to pay a portion of the extension costs in a CIAC. R. 24 at 97-98.

Further, customer-paid amounts are not counted as utility investments mandated by the Federal Energy Regulatory Commission ("FERC") and the United States Rural Utilities Service ("RUS"). Rel. App. 157 (citing *City of Buffalo Order*, PUC Add. 10). The CIAC also are not counted as utility investments for ratemaking purposes. Rel. App. 157. Treating these costs as utility expenses would be unfair and would not contribute to the goal of placing the displaced utility in the same position it would have occupied but for the municipal utility's acquisition. Rel. App. 157. Since CIAC are not costs of the

cooperative, these costs are appropriately excluded from the determination of avoided costs and the exclusion of these costs does not support a finding that the net revenue loss formula is no longer appropriate for determining compensation. Rel. App. 157. Further, the record in this case supports that these items are not counted as utility investments by FERC or RUS and these costs are not treated as utility investments for ratemaking purposes. R. 23, Eicher Surrebuttal at 19-21, Exh. DRE-9R2.

The Commission declined to accept Relator's claim that CIAC should be counted as part of the Cooperative's avoided costs here. Rel. App. 157. The Commission noted that the ALJ made no specific finding on this issue, but his adoption of Relator's proposal appeared to incorporate Relator's inclusion of those amounts in the Cooperative's avoided costs. Rel. App. 157.

C. Reasonableness Tests

The Commission rejected the ALJ's proposed "reasonableness" tests and other comparisons. Rel. App. 150. The proposed reasonableness tests did not reflect the application of the factors for determining compensation outlined by the statute and, therefore, were not appropriate measures to determine compensation in this case. Rel. App. 150; *see* Minn. Stat. § 216B.44 (b) (2005)

First, the Commission reviewed the ALJ's use of the margin-component comparison. Rel. App. 151. The ALJ accepted as fact Relator's argument that Lake Country's compensation award included a 40.4 percent margin, compared to Lake Country's system-average margin of 2.6 percent. Rel. App. 20-21 ¶¶ 38-39. The ALJ found that the disparity arose from Lake Country's flawed application of the net revenue

loss formula. Rel. App. 21 ¶ 41. However, as the Commission noted, the ALJ mistakenly determined that two different uses of the term “margin” were the same and comparable. Rel. App. 151.

The 2.6 percent margin referred to herein is the ratio between the amount remaining after all costs of providing service have been accounted for and total revenue. Rel. App. 151; R. 19 at 32; R. 23 at 29-31; R. 52 at 16-18. This figure is akin to profit in a for-profit enterprise. Rel. App. 151. The 40.4 percent margin is the ratio between the amount of the residual fixed costs, or “stranded costs,” of the Cooperative and the revenues the Cooperative would have received from customers in the annexed areas. Rel. App. 151; R. 23 at 29-31; R. 52 at 16-18. The 40.4 percent margin includes the 2.6 percent margin, as well as the costs the utility formerly recovered in revenues from the annexed areas and which it continues to incur, such as interest, depreciation, taxes, and overhead costs, among others. Rel. App. 151; R. 52 at 17. Although this difference was thoroughly addressed in testimony, the ALJ did not address the difference in these referenced margins. Rel. App. 20 ¶ 38; R. 19, Berg Rebuttal at 31-33; R. 24 at 108; R. 52 at 17. The ALJ mistakenly found that the large difference was due to a flawed application of the formula. Rel. App. 21 ¶ 41. However, because the two margins are not the same, the difference between the margins provided no indication of reasonableness between the parties’ proposed awards.

The Minnesota Department of Commerce (“Department”) outlined previous Commission-determined compensation awards and Commission-approved settlements. R. 18, Lusti Rebuttal at 10, Exh. DVL-4. The ALJ noted the Department’s exhibit as

another benchmark of reasonableness. Rel. App. 22 ¶ 45. However, these prior Commission decisions and approved settlements do not reflect an analysis of the compensation due to the displaced utility in the instant proceeding. Accordingly, the Commission declined to consider these prior decisions and settlements as a “reasonableness check” on the award. Rel. App. 151-152.

The Commission also declined to apply the gross revenue multiplier approach to determine compensation. Rel. App. 152-153. The ALJ proposed that the gross revenue multiplier formula could be applied in lieu of the net revenue loss calculation and as a check on reasonableness. Rel. App. 23 ¶ 49. The ALJ mistakenly found that the gross revenue multiplier method had been in use for many years. Rel. App. 22 ¶ 46. However, the Commission has never used the gross revenue multiplier method to set compensation and found to do so here would be inconsistent with the requirements of the statute. Rel. App. 153. The Commission specifically indicated in a very early service territory compensation case that it did not endorse the use of the gross multiplier method to set compensation. *See Findings of Fact, Conclusions of Law, and Order Setting Compensation for Service Extension, In re Application of City of Olivia to Extend its Municipal Elec. Serv. Area into an Area Served by Renville-Sibley Coop. Power Ass’n*, MPUC docket No. E288, 136/SA-85-93 (June 27, 1986) (“*Olivia I Order*”), Rel. Add. at 50. Although the Commission indicated it found the method useful in that case as a check on reasonableness, the Commission has not used the method since.

Further, in the *Olivia I Order*, the Commission did not characterize the method as one in which gross revenues are multiplied by two, as the ALJ in this case did, but as a

method in which gross revenues are multiplied by two or three. Rel. Add. at 51. The Commission determined that applying a gross revenue multiplier of three would not support the ALJ's finding that the Cooperative's proposed award was unreasonable. Rel. App. 153. Finally, as the Commission indicated, the gross revenue multiplier does not apply the statutory factors for determining compensation. Rel. App. 153; Minn. Stat. § 216B.44 (b) (2005). Accordingly, the Commission declined to accept either that the gross revenue multiplier demonstrated unreasonableness in the result or that it was an appropriate method for determining compensation. Rel. App. 153.

The Commission also declined to accept the ALJ's finding that the comparison between Relator's retail rate and Lake Country's proposed compensation rate supported the proposition that the Cooperative's rate was unreasonable. Rel. App. 154 and 24 ¶ 51. As the Commission observed, Relator's retail rate has no bearing on the statutory factors the Commission must consider in determining compensation and that rates "consistently and legitimately vary between utilities." Rel. App. 154 (citing Minn. Stat. § 216B.44 (b) (2005)). The Commission explained,

[u]tility rates vary according to complex and interrelated factors, such as economic conditions at the time major investments were required, rates of growth in the utility's service area, fuel source proximity, and other factors. These factors affect utilities in different ways at different times, making rate discrepancies normal. Over time, every utility's rates will vary in relation to those of other utilities.

Rel. App. 154 (citing *Order After Remand, In re City of White Bear Lake's Request for an Electric Utility Service Area Change Within its City Limits*, MPUC Docket No. E101, 002/SA-88-179, (April 12, 1990), PUC Add. 37).

IV. LOST REVENUES FOR FUTURE CUSTOMERS

Regarding lost revenues for future customers, the ALJ found that Lake Country did have facilities adjacent to the boundary of the acquired bare ground and that the area was receiving service within the meaning of § 216B.44(a) and prior decisions of the Commission and this Court. Rel. App. 15 ¶ 17 and 17 ¶ 25. The ALJ, however, applied a second criterion of whether Lake Country had made investments in the vicinity that make an award for lost revenues for future customers necessary to avoid stranded investments. Rel. App. 16-17 ¶ 23. The ALJ concluded, however, contrary to the evidence in the record, that no future customers were projected to locate in the annexed areas and therefore recommended no compensation for lost revenues for future customers. Rel. App. 17 ¶ 26.

The Commission rejected the ALJ's two-step method for determining whether an area was already receiving electric service within the meaning of the statute to allow compensation for future customers to Lake Country. Rel. App. 150. Although the ALJ concluded Lake Country met the two-step test, this test is contrary to the requirements of the statute and precedent established by the Commission and this Court. The Commission therefore awarded lost revenues for future customers on the basis that the area was receiving service within the meaning of the statute. Rel. App. 155.

Additionally, the Commission rejected the ALJ's determination that where no future customers were projected to locate, Lake Country was not entitled to lost revenues for future customers. Rel. App. 156. The Commission found that both parties projected some customers to locate in the areas and that Lake Country was entitled to lost revenues

from any future customers that did, in fact, locate in the areas. Rel. App. 156 (citing R. 17, Eicher Direct Exh. DRE-9 at 2; R. 19, Mattei Rebuttal at 8). The Commission explained that one of the distinct advantages to calculating compensation as a mill rate is that if no new customers materialize, the acquiring utility pays nothing for them. Rel. App. 156.

The Commission noted that the treatment of the issue of lost revenues for future customers in the *ALJ Report* mirrored the treatment of the issue in the ALJ's report in the *City of Buffalo* case. Rel. App. 155. At the time the *ALJ Report* was prepared in the instant matter, the Commission had not yet issued its *City of Buffalo Order*. When the Commission did decide that case, however, the Commission rejected a two-step method for determining whether to award compensation for lost revenues for future customers. *City of Buffalo Order*, PUC Add. 6. The Commission declined to accept the ALJ's findings, conclusions and recommendations on this issue for the same reasons as those set forth in the *City of Buffalo* and incorporated those reasons by reference here. Rel. App. 155.

In its *City of Buffalo Order*, the Commission explained that once the ALJ found the areas were "already receiving electric service," the test for receiving compensation had been met. PUC Add. 5. The Commission rejected the ALJ's two-step approach as inconsistent with established Commission precedent, inconsistent with longstanding and judicially-affirmed interpretations of Minn. Stat. § 216B.44, and inconsistent with the public interest. PUC Add. 6. The Commission noted that it had consistently determined and been upheld in its determination that compensation is owed to displaced utilities

when annexed areas are “already receiving service.” PUC Add. 6. In those decisions, the Commission illustrated its findings that displaced utilities were serving annexed areas with an overview of the system assets that would have been used to serve the areas. PUC Add. 6.

In its *City of Buffalo Order*, the Commission noted that the established precedent served the public interest more effectively than the alternative approach proposed by the City of Buffalo and adopted by the ALJ. PUC Add. 7. “The alternative approach could undermine service area stability and drive up costs if utilities felt compelled to install ‘recent’ and ‘significant’ investments near areas likely to be annexed.” PUC Add. 7. Such an analysis would introduce the irrelevant factor of municipal utility investments into what was already a complex equation. PUC Add. 7. As the Commission noted, “[w]hat is material is not Relator’s cost, but the justness of compensation awarded to the rural cooperative.” *Id.* (citing *North Park*, 470 N.W.2d at 528-29).

SCOPE OF REVIEW

An appeal from a decision and order of the Commission may be commenced in accordance with Minn. Stat. ch. 14. Minn. Stat. § 216B.52, subd. 1 (2004). In a judicial review of an agency decision:

the court may affirm the decision of the agency or remand the case for further proceedings; or it may reverse or modify the decision if the substantial rights of the petitioners may have been prejudiced because the administrative finding, inferences, conclusion, or decisions are:

- (a) in violation of constitutional provisions; or
- (b) in excess of the statutory authority or jurisdiction of the agency; or
- (c) made upon unlawful procedure; or
- (d) affected by other error of law; or
- (e) unsupported by substantial evidence in view of the entire record as submitted; or
- (f) arbitrary or capricious.

Minn. Stat. § 14.69 (2004). On appeal from an agency decision, the party seeking review bears the burden of proving that the agency's conclusions violate one or more provisions of Minn. Stat. § 14.69. *Markwardt v. State, Water Resources Bd.*, 254 N.W.2d 371, 374 (Minn. 1977).

The court reviews the Commission's factual findings to determine whether they are supported by substantial evidence or whether its conclusions are arbitrary and capricious. Minn. Stat. § 14.69 (2004); *In re Excess Surplus Status of Blue Cross & Blue Shield of Minn.*, 624 N.W.2d 264, 277-279 (Minn. 2001) ("*Blue Cross & Blue Shield*"). Substantial evidence for purposes of appellate review of an administrative agency's

decision is: (1) such evidence as a reasonable mind might accept as adequate to support a conclusion; (2) more than a scintilla of evidence; (3) more than some evidence; (4) more than any evidence; and (5) evidence considered in its entirety. *Cable Comm. Bd. v. Northwest Cable Comm. P'ship*, 356 N.W.2d 658, 668 (Minn. 1984) (citations omitted).

A reviewing court may not substitute its own judgment for that of an administrative agency when the finding is properly supported by the evidence. *Vicker v. Starkey*, 265 Minn. 464, 470, 122 N.W.2d 169, 173 (1963). Courts defer to the agency's fact-finding process and it is the challenger's burden to establish that the findings are not supported by the evidence. *Id.*

A decision may be deemed arbitrary and capricious if the decision reflects the agency's will and not its judgment. *Blue Cross & Blue Shield*, 624 N.W.2d at 277 (citation omitted). To satisfy the arbitrary and capricious test, the agency must explain the connection between the facts found and choices made. *Id.* An agency decision is not arbitrary and capricious if the agency, presented with opposing points of view, reaches a reasoned decision that rejects one point of view. *In re Detailing Criteria and Standards for Measuring an Electric Utility's Good Faith Efforts in Meeting the Renewable Energy Objectives Under Minn. Stat. § 216B.1691*, 700 N.W.2d 533, 539 (Minn. Ct. App. 2005), *aff'd*, 714 N.W.2d 426 (Minn. 2006) (citation omitted). A reviewing court will affirm the agency's decision if it was not arbitrary or capricious "even though [the court] may have reached a different conclusion had it been the fact-finder." *White v. Minnesota Dep't of Natural Resources*, 567 N.W.2d 724, 730 (Minn. Ct. App. 1997), *review denied* (Minn. Oct. 31, 1997).

Further, this Court accords deference to an agency's expertise that is exercised within the scope of its authority, its findings on conflicting testimony, the weight given to expert testimony, and the inferences reasonably drawn from the testimony. *Blue Cross & Blue Shield*, 624 N.W.2d at 278. Agency decisions enjoy a presumption of correctness and deference should be shown to agency expertise and special knowledge. *Id.* (citing *Reserve Mining Co. v. Herbst*, 256 N.W.2d at 824).

Relator mistakenly suggests that the Commission's decision is subject to *de novo* review. This Court retains the authority to review *de novo* errors of law which arise when an agency decision is based on the meaning of words in a statute, see *In re Denial of Eller Media Co.'s Application for Outdoor Advertising Permits*, 664 N.W.2d 1, 7 (Minn. 2003), but "an agency's interpretation of the statutes it administers is entitled to deference and should be upheld, absent a finding that it is in conflict with the express purpose of the Act and the intention of the legislature." *Geo. A. Hormel & Co. v. Asper*, 428 N.W.2d 47-48, 50 (Minn. 1988) (citations omitted); see also *Kandiyohi*, 455 N.W.2d at 104 (an agency decision is entitled to some deference when the statutory language is technical in nature and the agency interpretation of the statute is one of longstanding application) (citation omitted).

De novo review is only appropriate where the matter at issue is a question of law. There is no question of law in this case. The issues in this case turn on whether the evidence in the record supports the Commission's determination of appropriate compensation and whether the Commission's decision is arbitrary and capricious. Because the Commission's decision is based on substantial evidence in the record and

reflects the Commission's judgment and not its will, the Commission's decision should be affirmed.

ARGUMENT

I. THE COMMISSION'S DETERMINATION OF LOST REVENUES IS SUPPORTED BY SUBSTANTIAL EVIDENCE IN THE RECORD.

A. Standard Of Law.

In making a determination of service territory compensation, one factor the Commission must consider is loss of revenue to the utility formerly serving the area. Minn. Stat. § 216B.44 (b) (2005). The Commission applies an incremental approach using a "net revenue loss" method to determine lost revenue. Rel. App. 147. The formula was first developed in the complex *North Park* service territory compensation case, and it has been refined and clarified in subsequent cases as new issues have arisen. *Id.*; *North Park* Order Determining Compensation, PUC. Add. at 11-23, *aff'd*, 470 N.W.2d 525. The objective of the formula is to put the displaced utility in the same position it would have occupied but for the loss of service rights to the area for which compensation is being determined. Rel. App. 147; *North Park*, 470 N.W.2d at 528 ("compensation is needed to protect member customers, lenders and investors whose prior investments are rendered less usable and more expensive because of the loss of an opportunity to expand services in an annexed area").

B. The Commission Applies A Net Revenue Loss Method Of Determining Lost Revenues.

As the Commission explained in its *Order Determining Compensation*, the starting point for the analysis is to determine the gross revenues the displaced utility would have received if it were serving the area. Rel. App. 147. To determine gross revenues,

[t]he number of customers and the usage per customer are estimated for each year of the compensation period, which the Commission has set at ten years, to reflect the intermediate planning horizon of most Minnesota utilities. The utility's rates are then applied to these billing determinants to measure the gross revenues the utility would have received.

Rel. App. 147.

Second, avoided costs, those costs the displaced utility will avoid for not serving the areas, are determined. Rel. App. 147. Those avoided costs are then subtracted from gross revenues. Rel. App. 147-148. Finally, the yearly net revenue losses are reduced to present value and the present value amount is taken to be the net revenue loss. Rel. App. 148. Further, the net revenue loss amount is almost always converted to a mill rate and the compensation is paid at the mill rate over the compensation period. Rel. App. 148.

C. The Cooperative's 2000 Cost Of Service Study Does Not Accurately Reflect The Costs The Cooperative Will Avoid By Not Serving The Areas.

In this case, Relator sought an allocation of avoided costs based on the Cooperative's 2000 class cost of service study. Rel. App. 159. The Cooperative's 2000 class cost of service study identified all the costs of supplying electricity to Lake Country's general body of ratepayers at that time and allocated costs to different

customer classes on the basis of cost-of-service and other rate design principles. Rel. App. 159. However, this study is not a reliable guide to determine avoidable costs here.

As the Commission explained,

Allocating costs among classes of customers who are actually on a utility's system, contributing to the system's fixed costs through their monthly bills, is fundamentally different from determining what costs a utility will avoid – that is, will stop incurring – if it loses particular customers. In the first case, costs are properly allocated to ensure that active customers bear their fair share of fixed costs. In the second case, costs must be calculated incrementally, since not all the fixed costs allocated to particular customers will go away with the departing customers. Instead, the fixed costs formerly borne by the departing customers must be spread over those remaining on the utility's system.

Rel. App. 159. Thus, the Cooperative not only does not avoid these costs, but the Cooperative loses customers that would otherwise contribute to the recovery of these costs.

The Commission noted that it had most recently declined to adopt an allocation approach in the *City of Buffalo*. Rel. App. 159-160; PUC Add. 8-9. The Commission indicated that it declined to depart from its incremental approach here for those additional reasons cited in its *City of Buffalo Order*. Rel. App. 160; PUC Add. 8-9. The incremental approach determines the direct, incremental, financial impact that losing service rights has on a displaced utility, given that utility's operational requirements and the configuration of its system. Rel. App. 160 (citing *City of Buffalo Order*, PUC Add. 8-9). The incremental approach treats as avoided only those costs that are actually avoided by not serving the areas and protects the ratepayers of the displaced utility that may have

to pay more of the fixed costs of receiving service because there are now fewer customers from which the Cooperative may recover those costs. As the Commission noted, since the *North Park* case in 1990, the Commission has consistently applied an incremental approach to determining avoided costs, finding that this approach offers greater accuracy due to its tight focus on the specific situation of the displaced utility. Rel. App. 160.

In contrast, Relator's allocation method treats as avoided costs that continue to be incurred. Rel. App. 160. Because the 2000 study did not identify specific costs that could be avoided by the Cooperative losing service rights to the areas, the Commission declined to rely on the study in determining avoided costs in this case.

D. Costs The Cooperative No Longer Incurs Are Not Avoided Costs For Purposes Of Determining Appropriate Compensation.

The Commission also declined to use the 2000 cost of service study in determining avoided costs because the study included at least three significant costs that the Cooperative no longer incurs. These costs include a one-time special assessment of \$600,000 from GRE, a \$178,000 non-recurring surcharge from GRE, and \$1.66 million in substation charges that Lake Country no longer incurs because it purchased the substation. Lake Country does not avoid these costs by transferring service territory to Relator, and the Commission appropriately rejected the inclusion of these costs in avoided costs. Rel. App. 160.

Relator has argued that these rates are relevant because the Cooperative has had recent rate increases. Rel. Br. 9. However, as the Cooperative's witness testified, "Lake Country has increased its rates because there are other costs that are going up and I think

also that wholesale power costs . . . within the last 5 [years] have gone up. They went down for a period of time and now they're on the rise again. And that's been reflected in rate increases." R. 24 at 125:11-17. The Cooperative's Chief Executive Officer, Mr. Lemonds, testified that Lake Country instituted a three percent rate increase in 2004 due to rising costs and that the Cooperative would likely raise rates again in the future. R. 25 at 305-309. Thus, there is no dispute that the Cooperative instituted rate increases. The mere existence of rate increases, however, does not establish costs that will be avoided by not serving the areas at issue here. The fact that Lake Country implemented a rate increase does not support treating the costs identified above as avoided costs for purposes of determining appropriate compensation.

E. The Cooperative Will Not Realize Cost Savings By Postponing Or Cancelling System Improvements Or Upgrades Over The Compensation Period Due To The The Loss Of Service Rights To The Annexed Areas.

Relator included in its calculation of avoided costs approximately \$51,220 in avoided system investment associated with operation and maintenance costs, interest, depreciation and property taxes. Rel. App. 160. However, the record does not support the proposition that these costs will be avoided.

In this case, no system investments will be avoided by the Cooperative losing service rights to the annexed areas. Rel. App. 14-15 ¶ 16; R. 20, Seeling Rebuttal at 5. The record indicates that the only projects in Lake Country's long range plan connected with serving the annexed areas are scheduled to occur outside of the ten-year compensation period. Rel. App. 161; Rel. 14-15 ¶ 16. Accordingly, no system

investment costs are treated as avoided costs in determining appropriately compensation here.

Relator argues that its approach was based on the actual cost of Lake Country's facilities in and around the annexed areas and that its approach is not an average or allocation of system-wide costs. Rel. Br. 38.³ Relator claims that it applied the incremental approach to determine "system savings" and that this approach recognized that the Cooperative's system capacity can be used to serve other customers if they are not being used to serve customers in the annexed areas. Rel. Br. 39. Despite the name Relator attaches to its approach, what Relator advocates is an averaging/allocation approach, which attributes some portion of system costs that will not be avoided as avoided costs. There is nothing in the record to support treating these costs as avoided costs. Even where a portion of a facility could have been used to serve customers in the annexed areas were it not for the acquisition, that portion is not included in the avoided costs where those costs are not, in fact, avoided. Accordingly, the Commission declined to include the proposed \$51,220 as avoided costs. Rel. App. 161.

F. The Commission Appropriately Adjusted Proposed Amounts For Avoided Purchased Power Costs To Reflect The Load Factor Of The Annexed Areas And The Effect Of That Load Factor On Purchased Power Costs.

The Commission declined to adopt the Cooperative's proposed system-average costs, finding that it was unnecessary to use system-average costs when actual costs were

³ Relator also indicates that it did not rely on the 2000 rate study to determine these costs. The Commission excluded these costs because they were not avoided. Thus, the Relator's source for these particular cost figures is not at issue.

clearly different and could be determined with reasonable accuracy. Rel. App. 159. While the Cooperative indicated it would avoid 45.9 mills/kWh annually, Relator maintained that the appropriate figure was 61.0 mills/kWh annually. The Commission found that both figures were off the mark and that the most reasonable cost of purchased power was in between the two. Rel. App. 161.

Minnesota courts have long recognized the Commission's role in choosing the appropriate figures based on record evidence. "[A]n agency decision may be upheld where each witness testified that a different calculation was reasonable even though no witness gave testimony supporting the figure chosen by the Commission." *In re Petition of Northern States Power Gas Util. for Auth. to Change its Schedule of Gas Rates for Retail Customers Within the State of Minn.*, 519 N.W.2d 921, 926 (Minn. Ct. App. 1994) (citing *Re Petition of Northern States Power Co. for Auth. to Change its Sched. of Rates for Elec. Serv. in Minn.*, 416 N.W.2d 719, 724-25 (Minn. 1987); cf. *Montgomery Ward Co. v. County of Hennepin*, 482 N.W.2d 785, 791 (Minn. 1992) ("a tax court proceeding is not high-low arbitration where the decisionmaker must choose the figure submitted by one or the other party. The Tax Court brings its own expertise and judgment to the hearing, and its valuation need not be the same as that of any particular expert as long as it is within permissible limits and has meaningful and adequate evidentiary support").

In determining compensation, the Commission is not bound to choose the position advocated by either party. Where all numbers have flaws, the Commission must choose the best number based on the evidence presented. See *Qwest Corp. v. Koppendrayer, et al.*, 436 F.3d 859, 868 (8th Cir. 2005) (citation omitted) (noting that pursuant to 47

U.S.C. § 252 (b) (4), the Commission was required to make its decision based on the best information available where one party provided no evidence to the contrary). Where neither point advocated by the parties is persuasive, it is not arbitrary and capricious to adopt a middle ground. *Id.*

The Commission, as the agency with expertise in this matter, has authority to review the evidence in the record to determine the appropriate figure. This Court should not substitute its judgment for that of the Commission. *Reserve Mining Co. v. Herbst*, 256 N.W.2d 808, 825 (Minn. 1977). In this case, the Commission appropriately declined to adopt Relator's proposal, since it included costs that Relator admitted were not avoidable by the Cooperative. Rel. App. 161; R. 25 at 216 and 218. Relator's proposed amount failed to adjust for the significant effects of an off-peak rate differential in the rate structure of Lake Country's wholesale supplier. Rel. App. 161. The failure to make the adjustment inflated the purchased power costs by including non-existent demand charges and by treated discounted power as though it were purchased at full price. Rel. App. 161. Relator also based its calculations of purchased power costs on the 2000 rate study that allocated total system costs, some of which would continue after the acquisition, instead of determining the direct, incremental costs and, as noted above, counted as ongoing at least three significant costs the Cooperative no longer incurred. Rel. App. 161.

Alternatively, while Relator's proposed avoided costs were too high, the Cooperative's were too low. Rel. App. 161. The Cooperative's alternative assumed too

high a load factor for the acquired customers.⁴ Rel. App. 162. However, the data to determine the load factor represented by the acquired customers did not exist. Rel. App. 162. To compensate for this lack of data, the Cooperative assumed a system average load factor in calculating purchased power cost. Rel. App. 162; Rel. App. 18 ¶ 31; R. 17, Eicher Direct at 23. Relator, however, noted that the Cooperative has several large, high-load-factor industrial customers that raise the load factor above that that could reasonably be expected from the customers in the largely-residential annexed areas. Rel. App. 162; R. 22, Berg Surrebuttal Exh. DAB-1 at 2.

In response, the Cooperative agreed that the avoided purchase cost might be higher than the system average, but that it was not as high as that claimed by Relator. Rel. App. 162; R. 24 at 53:18-20. In his testimony, the Cooperative's witness stated that he had included a power cost higher than system average and indicated that the avoided purchased power costs may be higher than 45 mills/kWh, but that it was not likely higher than 48 or 50 mills/kWh, and that it certainly was not up in the 60 mills/kWh range. Rel. App. 162; R. 24 at 53:13-20.

The Commission found that it could not adopt either party's avoided-cost figure for purchased power costs. Rel. App. 162. Since the data required to precisely determine the costs did not exist, the Commission examined the record as a whole and applied its

⁴ As the Commission explained, "load factor" is the relationship between the amount of electricity consumed at times of peak usage on the system and the total amount used. Rel. App. 162. The Commission notes its significance because the Cooperative purchases power from its wholesale supplier under a two-part rate: demand and energy. Rel. App. 162. The higher the load factor is, the lower the cost of purchased power. Rel. App. 162.

judgment to make the most reasonably accurate determination possible. Rel. App. 162. The Commission weighed all the factors to set the purchased-power component of avoided costs at \$76,770 per year or 51 mill/kWh. Rel. App. 162. This mill rate fell within the range of reasonableness identified in the record by the Cooperative's witness. Rel. App. 162. (citing R. 24 at 53: 18-20). The Commission found this evidence probative and credible, since the Cooperative had first-hand knowledge of its load characteristics and that the record demonstrates the Cooperative applied the net revenue loss method in an accurate and straightforward manner throughout the case. Rel. App. 162.; Rel. App. 18 ¶ 29-33. However, since the Cooperative had the burden of proof and incentive to set the amount as low as possible, the Commission adopted a figure at the high end of Lake Country's range of reasonableness. Rel. App. 162.

Additionally, the Commission found that the rate of 51 mills/kWh approximates the mill rate proposed by Relator once that rate was adjusted for the anomalies resulting from Relator's use of the 2000 ratemaking study and its failure to recognize the effects of the off-peak discount the Cooperative received from its wholesale provider. Rel. App. 162; Rel. App. 12. Incorporating the 51 mills/kWh rate into the avoided cost equation resulted in a total compensation rate of 30 mills/kWh. Rel. App. 162. The Commission considered the entire record, the ranges identified by the parties, and evidence regarding necessary adjustments in determining the appropriate amount for avoided purchased power costs.

Contrary to the assertions of Relator, the Commission did not “unconditionally adopt” the Cooperative’s range in testimony.⁵ Rel. Br. 36. Rather, the individual Commissioners and the Commission as a whole carefully reviewed the evidence presented to identify the appropriate mill rate for compensation in this case. Rel. App. 162 and 137-139. The Commissioners identified the purchase power expense figures proposed by the parties, reviewed the testimony in the record and adjusted as necessary to reflect the load factor of the areas at issue. Rel. App. 141-142. The Commissioners acknowledged that they did not have exact figures to make the adjustment because the data did not exist. Rel. App. 142. As Commissioner Nickolai so aptly noted, the Commission’s decisionmaking in a case such as this, where precise data is lacking and a range of figures is offered, is similar to the process of determining rate of return in a rate case:

You’ve got some evidence out there, you’ve got basically a range, based on that range you’ve got to make some judgments. And that’s what we do when we see a variety of information on rates of return, I think that’s what we have to do here, because we don’t have absolute precision on this issue, but we know that the 35.4 is built in with something that’s too high, because it’s built on the system average, we just don’t know precisely what the lower is.

⁵ Relator cites the Commission’s decision in *Olivia* for the proposition that the Commission has previously determined purchased power costs should not dictate compensation. Rel. Br. 33. In the *Olivia I Order*, the Commission stated that, “[o]ne utility should not receive a higher acquisition award than another, for example, simply because it has higher purchased power costs.” Rel. Br. 33 (citing *Olivia I Order*, Rel. Add. at 51). However, Relator neglects to include that the statement was made with respect to the Commission’s explicit decision not to endorse the use of the gross revenue multiplier approach to determine compensation and the statement was not the holding in that case. *Olivia I Order*, Rel. Add. at 50-51.

Rel. App. 142. After further discussion, Commissioner Reha stated, “I want to take into account the load factor issue, and I understand now that it’s a range, and it’s not a definitive number, and the range is somewhere between 4 and 6.” Rel. App. 142.

The Commissioners acknowledged the difficulty of making these complex calculations in the meeting. Rel. App. 143.⁶ The Commission recognized the possibility that the calculations might need to be adjusted. Rel. App. 143. As Relator notes in its brief, Commissioner Johnson stated “can I take my vote back? I don’t like it.” Rel. Br. 17. However, Relator neglects to note the context in which the statement was made. Commissioner Johnson made the statement in response to Chair Koppendrayer indicating that he did not like doing the actual computations at the hearing. Rel. App. 143. Chair Koppendrayer correctly noted, however, that the Commission could consider the matter on its own motion at any time if an error had been made. Rel. App. 143; *see* Minn. Stat. § 216B.25 (“The Commission may at any time, on its own motion . . . rescind, alter or amend any order”). No Commissioner, including Commissioner Johnson, brought such a motion.

⁶ In *City of Buffalo*, the Commission made its decisions regarding the principles governing the compensation methodology and asked the parties to submit the mill rates resulting from those decisions as compliance filings. PUC Add. 1. The Commission did not calculate the resulting mill rate at the hearing.

II. THE COMMISSION APPROPRIATELY DECLINED TO APPLY THE PROPOSED “REASONABLENESS CHECKS” TO ITS DETERMINATION OF APPROPRIATE COMPENSATION.

A. Standard Of Law

Relator argues that the Commission’s decision was arbitrary and capricious for failing to apply a reasonableness check to the compensation award. In determining appropriate compensation, the Commission is to consider the “original cost of the property, less depreciation, loss of revenue to the utility formerly serving the area, expenses resulting from integration of facilities, and other appropriate factors.” Minn. Stat. § 216B.44 (b) (2005). No statute, rule or case requires the Commission to apply a “reasonableness check” on the compensation decision. Further, the “reasonableness checks” advocated by Relator bear no relationship to the requirements of the statute and the Commission cannot adopt a reasonableness test untethered to these statutory factors.

Although the Commission may have found a reasonableness check of limited value in the first compensation determination it made, a case with facts vastly different from those present here, Rel. Add. at 51, the Commission has not applied that type of check in the most recent cases with facts more similar in this case. *See City of Buffalo*, PUC Add. 1; *Celestica*, Rel. Add. 124. Rather, the Commission, given its over 20 years of experience of deciding service territory matters, relies on a careful analysis of the facts in the case to determine appropriate compensation to the displaced utility.

B. Prior Settlements Are Not An Appropriate “Reasonableness Check” On The Determination Of Appropriate Compensation.

In support of its argument that the Commission’s decision was not reasonable for Relator, Relator also cites to the testimony of the Department of Commerce as supporting the proposition that the Commission has established a “general rule” of compensation of less than 10 mills. R. Br. 13. However, settlements represent compromises between the parties and not the considered judgment of the Commission. Settlements must be reasonable for the Commission to approve them, but approval does not signify the Commission would have achieved the same result.

Thus, while the Department provided testimony indicating that the cited past Commission Orders and settlements gave a general indication of value that could be used as a “frame of reference” in determining compensation in this case, the Department did not indicate that these settlements had any relationship to the facts of this case. R. 18, Lusti Rebuttal at 11. Accordingly, the Commission appropriately declined to use those past orders and settlements as a guide to the determination of compensation here. Rel. App. 151-152. As the Commission noted, “every compensation decision is unique, based on detailed facts specific to the displaced utility and the service area at issue.” Rel. App. 151. The Commission explained,

[u]tility costs vary significantly with geography, topography, population density, system capacity, fuel source proximity, terms of purchased power contracts, timing (and therefore capital costs) of major investments, and other factors. The costs of serving specific areas also vary with these factors and revenue loss can and does produce significantly different results in different situations, making final outcomes in previous cases of little significance in resolving subsequent cases.

Rel. App. 152.

Accordingly, previous settlements and Commission decisions cannot be considered evidence of reasonableness in subsequent, unrelated cases.⁷ Settlements reflect compromises between the parties and do not reflect what the determination would be if the issues were fully litigated. The Commission appropriately declined to adopt previous settlements and Commission-determined compensation amounts as a “reasonableness check.”

C. The Gross Revenue Multiplier Approach Advocated By Relator Does Not Reflect The Factors To Be Used To Determine Compensation Under § 216B.44.

The Commission reviewed the evidence in the record, the methodologies presented, and made adjustments accordingly to determine appropriate compensation in this case. Because the use of the gross revenue multiplier does not reflect an application

⁷ Relator notes that the Commission has indicated that it must avoid different loss of revenue awards for virtually identical acquired areas. Rel. Br. 25 (citing *Olivia I Order*, Rel. Add. 49-50). Relator fails to explain, however, that the Commission made the statement in relation to its decision to decline to adopt Relator’s method for determining the compensation time period and is not probative to Relator’s argument regarding past settlements. *Olivia I Order*, Rel. Add. 49. Further, the Commission stated in its *Olivia I Order* that different loss of revenue awards could occur, “if the acquired areas were formerly served by utilities with essentially different types of service areas and, consequently, different growth rates.” Rel. Add. 50.

of the statutory factors, the Commission declined to adopt it. Although the ALJ found that there may be benefits to the use of a gross revenue multiplier for mature service areas and that the gross revenue multiplier formula could be used, the ALJ appropriately noted that the methodology used to determine compensation is a matter of policy and that decision was for the Commission. Rel. App. 23 and 27.

While Relator is correct that the Commission stated in *Olivia* that a gross revenue multiplier is a useful check on reasonableness, Rel. Br. 26 (citing Rel. Add. 51), Relator fails to note that the Commission specified that the method was not itself sufficient to determine compensation. The Commission specifically did not endorse, “the use of a gross revenue multiplier for proceedings of this type because certain expenses of the utility, which are passed through in utility rates and therefore reflected in total revenue, are highly variable.” *Olivia I Order*, Rel. Add. at 50. As noted, the Commission has not utilized this comparison in subsequent service territory cases.

D. Relator’s Proposed Comparison Of The Margins At Issue Is Inaccurate.

As previously noted, the “margin” comparison used by the ALJ is flawed in that it inappropriately compares two different types of “margin” as if they were the same. The 2.6 percent “margin” figure reflects the amount considered “patronage capital” for the Cooperative and what would be referred to as “profit” in a for-profit enterprise. This figure represents the ratio between total revenues and total costs. Rel. App. 151; R. 23, Eicher Surrebuttal at 29-31. As a result of the acquisition, the Cooperative will lose these margins or “patronage capital” that would have been earned on sales in the proposed

areas. In a cooperative, margins are earned each year and assigned back to the member-consumers. R. 17, Eicher Direct at 17 and Exh. DRE-4. These margins are not, however, immediately paid back to the member-consumers, but are retained by the Cooperative for a period of time and are used as a source of equity. R. 17, Eicher Direct at 17-18. These amounts are also invested in distribution facilities and may serve to reduce the amount the Cooperative must borrow. R. 17, Eicher Direct at 18, Exh. DRE-4.

The 40.4 percent figure is the net loss of revenue, and includes profit, as well as other amounts. Rel. App. 151; R. 23, Eicher Surrebuttal at 29-31. The 40.4 percent figure represents the ratio between the stranded costs the utility cannot avoid by not serving the areas and the revenues it would have received from customers within the areas. Rel. App. 151; R. 23, Eicher Surrebuttal at 29-31. This amount includes the 2.6 percent patronage capital amount, as well as other costs the utility formerly recovered in revenues from the annexed areas. Rel. App. 151; R. 23, Eicher Surrebuttal at 29-31.

Because the two figures were clearly not comparable, it was inappropriate for the ALJ to use these figures as evidence of reasonableness. Further, these figures do not relate to the factors outlined under the statute and are therefore not relevant to the determination of "appropriate compensation."

E. Any Comparisons To Relator's Retail Rate Are Misplaced.

The Commission appropriately declined to consider Relator's retail rate for its municipal utility customers in determining appropriate compensation for the Cooperative. Relator argues that the Cooperative's proposed award is equal to 62.9 percent of Relator's average retail rate and that this reflects a nearly two-thirds markup in Relator's

customers' rates in order to pay for the annexed areas. Rel. Br. 28 (citing R. 19, Mattei Rebuttal at 34). Relator fails to establish, however, how its retail rate relates to the factors for determining appropriate compensation under Minn. Stat. § 216B.44. Rather, Relator cites to a portion of the *Olivia I Order After Rehearing* for support, but fails to include the whole cite and the context for the cite. In the statement cited, the Commission was clarifying its previous order to make clear that,

[t]he task set by Minn. Stat. § 216B.44 [] for the Commission is to determine a price that fairly reflects the loss to the Cooperative. Even though the record contains evidence with respect to rate effects and Relator's ability to afford the acquisition, *such evidence is not directly pertinent to satisfying the dictates of the relevant statute.* Once the price is set, Relator is the party which must determine whether it can and will proceed with the acquisition at that price.

Rel. Add. at 62 (emphasis added). In clarifying its statements from its *Olivia I Order*, the Commission explained that it, "never meant to imply that the price should be reduced to a level which would be less than the actual current loss sustained by the Cooperative in giving up the area. Such action would have violated Minn. Stat. § 216B.44[]." *Olivia Order After Rehearing*, Rel. Add. 63.

Relator's argument that the Commission's determination of compensation is troublesome given the orderly annexation agreement with Grand Rapids Township pursuant to which Relator will annex areas every two years, and that Relator will face "ever-increasing" awards, is misleading. Rel. Br. 23 (citing Ex. 20 at 5). There is no basis for the assertion that Relator will face "ever increasing" awards. Each compensation decision is based on the facts in that case.

Most important, however, is that Relator is not required to acquire the service territory of the utility currently serving annexed areas. *See* Minn. Stat. § 216B.41 (the annexation of any part of the assigned service area of an electric utility within the boundaries of a municipality will not impair the rights of the electric utility to provide electric service in the annexed area unless the municipality owns and operates an electric utility and elects to purchase the facilities and property of the electric utility).

The Legislature has granted municipalities the right to acquire the service rights to areas within their municipal boundaries if those municipalities choose. Minn. Stat. § 216B.44 (a) (2005). Thus, it is Relator's choice to go forward with the acquisition. The Legislature has not required municipalities to acquire those service rights. Accordingly, the Legislature did not include the potential impact on Relator's rates should it decide to proceed with the transaction as a factor for the Commission to consider in determining appropriate compensation for the displaced utility. Minn. Stat. § 216B.44 (b) (2005).

III. THE DETERMINATION THAT MUST BE MADE IS THE APPROPRIATE COMPENSATION TO THE DISPLACED UTILITY AND, THEREFORE, THE COMMISSION'S DECISION IS NOT UNCONSTITUTIONAL.

A. Standard of Law.

Relator's claim that the award is unconstitutional is without merit. Relator argues that the Commission has violated its constitutional due process right to a reasonable compensation award. Relator does not cite any law to support its position that the Commission's decision on how to compensate the displaced utility must result in what Relator views as a reasonable decision. The Commission is required to determine

appropriate compensation for the displaced utility. Minn. Stat. § 216B.44 (2005). The Commission is not required to determine what compensation Relator would like to pay.

B. The Commission's Decision Does Not Unconstitutionally Deprive Relator of Its Due Process Rights.

Relator cites to several cases that have no bearing on the Commission's decision here. First, Relator cites *In re Imprv. of Third St., St. Paul*, 225 N.W.2d 92 (Minn. 1929), for the proposition that a condemnation award will be set aside as unfair and impartial where it is grossly disproportionate to the value of the land taken. Rel. Br. 21. Even if this case could be applied here, Relator fails to address that, in that case, it was established that the award was approximately half of the current value. 225 N.W.2d at 92-93. There is no indication in the present case that the Commission's determination of appropriate compensation does not reflect the value of the service territory at issue and there is no evidence that the Commission's determination is "grossly disproportionate" to the value of the service territory.

Further, there is no indication that the determination of appropriate compensation is "inadequate or excessive." Rel. Br. 21; see *Flanagan v. Lindberg*, 404 N.W.2d 799,800 (Minn. 1987). Rather, the determination of compensation is based on the carefully developed facts of this case. The substantial evidence in the record supports the compensation figure outlined by the Commission and the Commission's decision must be affirmed accordingly.

Although Relator cites to investments made by the City of Rochester and the City of Buffalo to serve annexed areas those municipal utilities acquired from another utility,

the issue to be resolved is the appropriate compensation for the displaced utility. *North Park*, 470 N.W.2d at 528-29. The cities' investments and anticipated costs to provide service are not relevant to the determination of appropriate compensation to the displaced utility.

IV. THE COMMISSION APPROPRIATELY MADE AN INDEPENDENT DECISION BASED ON THE RECORD.

A. Standard of Law

The Commission is required to make an independent decision based on the record before it and the Commission's final decision must be supported by substantial evidence. *See City of Moorhead v. Minn. Puc. Util. Comm'n*, 343 N.W.2d 343, 846 (Min., 1984). The Commission is not required to treat the ALJ's recommendation with the same deference an appellate court must accord the findings of a trial court, as the ALJ's report is only one part of the record. *See Blue Cross & Blue Shield*, 624 N.W.2d at 278 (citation omitted). Agencies must not "rubber stamp" the findings of a hearing examiner. *Id.* Agencies may "utilize their experience, technical competence, and specialized knowledge in the evaluation of the evidence in the hearing record." Minn. Stat. § 14.60, subd. 4 (2005).

B. The Commission Did Not Inappropriately Reject The Credibility Findings of the ALJ.

Contrary to Relator's assertions, the Commission did not inappropriately reject the ALJ's witness credibility findings. The ALJ did not weigh the credibility or truthfulness of the parties' witnesses to reach his conclusions. Rather, the ALJ found that the result

achieved by Relator's proposed method was more reasonable. Rel. App. 23 ¶ 48 ("Relator's assessment of costs more accurately identifies the actual costs avoided by Lake Country in no longer serving the customers in Areas 1 and 2."). The Commission appropriately noted that the *ALJ Report* contained few findings of fact, the ALJ did not systematically apply the net revenue loss compensation formula to either party's version of the facts, and the ALJ did not analyze the accuracy of either party's formula inputs. Rel. App. 150. Rather, the *ALJ Report* focused only on the outcomes, analyzing their proposed "reasonableness" in relation to each other and with other benchmarks that did not reflect the application of the factors for determining compensation outlined in the statute. The comparisons used by the ALJ were either misplaced, non-probative or factually incorrect. Rel. App. 150.

Relator argues that deference is warranted where the ALJ has selected one expert's proposed methodology over another. Rel. Br. 31. However, the ALJ in this proceeding did not select one methodology over another or base his decision on the credentials of an expert or the credibility of an expert at hearing. Rather, the ALJ looked only at results and applied inappropriate comparisons to support his choice. Thus, there is no basis by which the Commission should defer to the ALJ's findings on these issues.

Significantly, Relator fails to acknowledge that the ALJ specifically identified that he developed an "alternative" approach to determining compensation for the Commission to consider. Rel. App. 27 ("an alternative has been proposed to more easily calculate the loss of revenue compensation to be paid to cooperatives"). The ALJ recognized that, although he developed an alternative approach, "the ultimate decision regarding the

compensation formula to be used is a matter of policy. That decision belongs to the Commission.” Rel. App. 27. The Commission found no reason to depart from past judicial precedent and policy of the Commission in this case. Rel. App. 150.

V. REMARKS OF COMMISSIONERS DURING THE HEARING REFLECT THE COMMISSION’S DELIBERATIVE PROCESS.

Relator cites to various remarks of the Commissioners at hearing to support its contention that the decision was arbitrary and capricious. Statements of individual commissioners during the course of the proceeding do not support a finding that the Commission based its decision on evidence outside of the record or that the decision was arbitrary or capricious. The statements of individual commissioners during the course of the proceeding reflect the five-member Commission’s deliberative process and do not by themselves establish the foundation upon which any particular decision is based. The record reflects a careful and thorough review of the record before it and a thoughtful application of the facts.

The Commission’s decision is reflected in its order. The *Order Determining Compensation* clearly demonstrates that the Commission based its decision on the evidence in the record. The issue in this case is whether the Commission’s decision is supported by substantial evidence. See *In re Petition of Northern States Power Co. For Authority To Change Its Schedule of Rates for Elec. Serv. in Minn.*, 416 N.W.2d 719, 728 (Minn. 1987) (“Because the record contains sufficient evidence to sustain the MPUC decision on this issue it is unnecessary for us to address NSP’s contention that MPUC had improperly relied on post-hearing evidence”). Because the record reflects an

extensive analysis of the amounts and factors considered to arrive at appropriate compensation, that question must be answered in the affirmative. Further, the Commission has fully explained the connection between the facts found and the conclusions made. The Commission's decision reflects the Commission's judgment and cannot be described as arbitrary and capricious.

VI. THE COMMISSION APPROPRIATELY AWARDED LOST REVENUES FOR FUTURE CUSTOMERS FOR AREAS THAT WERE "ALREADY RECEIVING ELECTRIC SERVICE" UNDER § 216B.44.

The annexed areas are already receiving electric service from Lake Country and, therefore, Lake Country is entitled to lost revenues for future customers. Minn. Stat. § 216B.44 (2004). As discussed below, prior decisions of the Commission and this Court support this result. Relator has not established how the statute and these prior holdings preclude the Commission's decision. Further, although Relator discusses acquiring municipalities' investments and expenditures, Relator's costs are not relevant to the determination of appropriate compensation for the displaced utility.

A. Standard of Law.

This Court has consistently held that if an area is already receiving electric service, the displaced utility is entitled to compensation, including lost revenues for future customers. *Kandiyohi*, 455 N.W.2d at 105-106 (the test is consistent with the legislative intent behind assigning areas to different public utilities); *North Park*, 470 N.W.2d at 528 (this interpretation "encourages rural cooperatives to make investments necessary to provide power throughout their service territory. Because power plants require years of planning, utilities must be willing to make investments long before actual need");

Rochester, 556 N.W.2d at 614 (noting that Minn. Stat. § 216B.40 provides electric utilities with the right to provide electric service to each and every present and future customer in its assigned service area).

The test for whether an area is “already receiving electric service” is whether the utility has facilities in place capable of providing the area with service. *Rochester*, 556 N.W.2d at 614 (citing *Kandiyohi*, 455 N.W.2d at 105). This issue has been addressed by this Court and by the Commission many times. *Kandiyohi*, 455 N.W.2d 102; *North Park*, 470 N.W.2d 525; *Rochester*, 556 N.W.2d 611.⁸ The reason that test matters, however, is that if the annexed areas are already receiving electric service, the Commission may determine appropriate compensation, considering the original cost of the property, less depreciation, loss of revenue to the utility formerly serving the area, expenses resulting from integration of facilities, and other appropriate factors. Minn. Stat. § 216B.44 (b) (2005). The Commission’s decision here is consistent with the language of the statute, prior Commission orders, and consistent with these previous decisions from this Court.

⁸ Relator points out that Respondents are likely to cite to this Court’s recent unpublished case affirming the Commission’s determination of service territory compensation, including an award of lost revenues for future customers. Rel. Br. 22; see *City of Buffalo* 2006 WL 1229596, review denied. Relator correctly notes that unpublished opinions of the Court of Appeals are not precedential. Rel. Br. 22 (citing Minn. Stat. § 480A.08, subd. 3). Relator fails to acknowledge, however, that in advocating a radical departure from this Court’s order issued only four months ago, Relator also asks this Court to depart from its published decisions issued in 1990, 1991 and 1996. See *Kandiyohi*, 455 N.W.2d 102; *North Park Addition*, 470 N.W.2d 525; *Rochester*, 556 N.W.2d 611.

B. The Commission Determined That The Areas Were Already Receiving Electric Service From Lake Country And, Therefore, Lake Country Was Entitled To Lost Revenues For Future Customers.

The ALJ found that the areas at issue were receiving electric service from the Cooperative. Contrary to the statute and prior decisions of this Court and the Commission, however, the ALJ applied a two-step test, first determining whether the areas were already receiving electric service within the meaning of the statute and, second, requiring evidence that the assigned utility has made investments in the vicinity that make compensation necessary to avoid stranded investments. Rel. App. 16 ¶¶22-23; Rel. App. 155. The accompanying memorandum indicates that the analysis is offered as an alternative approach with advantages over existing practice in the form of greater certainty and more expeditious handling of compensation claims. Rel. App. 26-27.

The ALJ found that the Cooperative here met the two-step test but declined to award compensation because he found that no customers were expected to locate in the areas at issue. Rel. App. 17 ¶ 26. The Commission declined to accept both the ALJ's analysis of whether the areas met the threshold requirements and that no compensation was due since no future customers were anticipated. Rel. App. 155. The Commission declined to accept this analysis for the reasons set forth in its *City of Buffalo Order*, and the Commission incorporated those reasons by reference. Rel. App. 155; PUC Add. 5-8.

As noted in the *City of Buffalo Order*, the two-step approach is not supported by the language of the statute. To be eligible for lost revenues for future customers, the displaced utility must demonstrate that the areas are already receiving electric service. In the instant matter, the annexed areas are already receiving electric service and, therefore,

the test of whether the displaced utility is entitled to compensation, including lost revenues for future customers, is met. Neither the Commission nor this Court has interpreted the statute to include the two-step test applied by the ALJ. Neither the Commission nor this Court should adopt such an approach now.

Additionally, although the ALJ found that there were no anticipated future customers, Rel. App. 21 ¶ 42-43, the evidence in the record indicates that some customers are expected to locate in the areas. R. 17, Eicher Direct Exh. DRE-9 at 2. Relator's witness indicated that as many as 20 future customers could locate in the areas, although he cautioned that the estimate could be generous. R. 29, Mattei Rebuttal at 8. Since the areas at issue were "already receiving electric service" under the statute and the record demonstrated that some future customers were anticipated, the Commission awarded lost revenues for future customers.

Further, the distinct advantage to calculating compensation as a mill rate is that it protects both Relator and the Cooperative from inaccuracies in these predictions. By reducing the compensation award for future customers to the mill rate, compensation for future customers is only paid if there are, in fact, future customers.

CONCLUSION

Based on the foregoing, the Commission respectfully requests the Court affirm the Commission's *Order Determining Compensation*.

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CERTIFICATE OF COMPLIANCE

WITH MINN. R. APP. P 132.01, Subd. 3

The undersigned certifies that the Brief submitted herein contains 13,703 words and complies with the type/volume limitations of the Minnesota Rules of Appellate Procedure 132. This Brief was prepared using a proportional spaced font size of 13 pt. The word count is stated in reliance on Microsoft Word 2003, the word processing system used to prepare this Brief.


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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).