

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE
PUBLIC UTILITIES COMMISSION

In the Matter of the Application of the Grand Rapids Public Utilities Commission to Extend its Assigned Service Area into the Area Presently Served by Lake Country Power

**FINDINGS OF FACT,
CONCLUSIONS, AND
RECOMMENDED ORDER**

The above-entitled matter came on for an evidentiary hearing before Administrative Law Judge Allan W. Klein on June 29 and 30, 2004 in Saint Paul, Minnesota. The hearing record remained open after the hearing for submission of posthearing briefs. The hearing record in this matter closed on December 2, 2004.

Kathleen M. Brennan and Andrew J. Shea, Attorneys at Law, McGrann, Shea, Anderson, Carnival, Straughn & Lamb, Chartered, 800 Nicollet Mall, Suite 2600, Minneapolis, MN 55402-7035, appeared for the City of Grand Rapids (City).

Harold LeVander, Jr., Attorney at Law, Felhaber, Larson, Fenlon & Vogt, P.A., 444 Cedar Street, Suite 2100, Saint Paul, MN 55101-2136, appeared for Lake County Power Cooperative Electric Association (Lake Country).

Ginny Zeller, Assistant Attorney General, 445 Minnesota Street, Suite 1400, Saint Paul, Minnesota 55101-2131, appeared for the Minnesota Department of Commerce (Department).

Stuart Mitchell, Rate Analyst, 121 Seventh Place East, Suite 350, Saint Paul, Minnesota, appeared on behalf of the Staff of the Minnesota Public Utilities Commission (Commission or PUC).

NOTICE

Notice is hereby given that, pursuant to Minn. Stat. § 14.61, and the Rules of Practice of the Minnesota Public Utilities Commission ("Commission") and the Office of Administrative Hearings, exceptions to this Report, if any, by any party adversely affected must be filed according to the schedule that the Commission will announce. Exceptions must be specific and stated and numbered separately. Proposed Findings of Fact, Conclusions and Order should be included, and copies thereof shall be served upon all parties. Oral argument before a majority of the Commission will be permitted to all parties adversely affected by the Administrative Law Judge's recommendation who request such argument. Such request must accompany the filed exceptions or reply (if

any), and an original and 15 copies of each document should be filed with the Commission.

The Commission will make the final determination of the matter after the expiration of the period for filing exceptions as set forth above, or after oral argument, if such is requested and one is held.

STATEMENT OF ISSUES

Through this proceeding, the parties have resolved all but the following issues:

- What is the appropriate level of compensation for lost revenue from existing customers?
- Over what period should lost revenue from customers be calculated?
- Is Lake Country serving an area within its service territory when no customers are located in the area and there are no customers anticipated there for the next ten years?
- Under what circumstances should Lake County receive compensation for lost revenue from future customers?
- What is the appropriate level of compensation for lost revenue from future customers?

In addition to the above contested issues, the City and Lake Country have agreed on three other items of compensation. A Finding on those items has been included in this Report, along with an analysis of the disputed issues.

Based upon all the proceedings herein, the Administrative Law Judge makes the following:

FINDINGS OF FACT

Jurisdictional-Procedural Background

1. On June 12, 2003, the City filed a Petition with the Commission under Minn. Stat. § 216B.44, requesting extension of the City's assigned service area to include two recently annexed areas. Area 1 is a 56-acre parcel known as the Stoeke-Maxwell Addition that is located in the southeast portion of the City. Area 2 is located in the western part of the City. Area 2 is composed of the Mississippi Heights Addition and the Remer-Deschepper Addition, totaling 362 acres.^[1] Both Areas 1 and 2 fall within the assigned service area of Lake Country. Lake Country joined the City in asking for a contested case hearing on the City's Petition. The City also requested extension of its service area to include a small parcel in the City of La Prairie (referred to as "Mary Ann Drive").

2. On October 16, 2003, the Commission issued an Order denying the City's request for reassignment of Mary Ann Drive to the City's service area and issued the Notice and Order for Hearing directing that a contested case hearing be convened to determine the amount of compensation that the City should pay to Lake Country for the adjustment of the assigned service territories for Areas 1 and 2.

Description of the Utilities' Service Areas

3. The City of Grand Rapids is located along the Mississippi River in Itasca County. The City is the county seat. Surrounding the City is Grand Rapids Township (Township). Lake Pokegama is situated to the southwest of the City. The City of La Prairie abuts the City to the east. To the northwest is the City of Cohasset. Lake Country serves the industrial park being established by Cohasset, which is located within the Cohasset municipal boundary, along U.S. Highway 2.^[2]

4. The City has a population of approximately 7,764.^[3] The Township has a population of 3,378. La Prairie has a population of less than 700.^[4] The City experienced a population loss of 212 residents over the decade from 1990 to 2000.^[5]

5. The City provides electricity to the area within its municipal boundary through the Grand Rapids Public Utilities Commission (GRPUC).^[6] The City has 6,525 electric meters.^[7] One large commercial electric customer within the municipal boundary receives service from a supplier other than the City. The City's annual sales in kilowatt hours (kWh) is approximately 147 million kWh.^[8]

6. Lake Country provides electricity to a large area outside of municipal utility service boundaries in Aitkin, Carlton, Cass, Itasca, Koochiching, Lake, Pine, and St. Louis counties. Lake Country's service area completely surrounds City. Over its entire service area, Lake Country serves approximately 46,000 electric meters. Lake Country's annual sales are just above 600 million kWh.^[9]

7. From east of the City, Lake Country provides electricity to its customers in Area 1 through a 12,500 volt distribution line.^[10] From west of the City, Lake Country has a 12,500 volt distribution line that runs south along the western boundary of Segment 2B, continuing southeast along U.S. Highway 2.^[11] The line terminates at the southeast corner of Segment 2A.^[12]

Description of the Annexed Service Areas

8. Area 1 is located on the southeastern end of the City, between River Road and the south bank of the Mississippi River. Area 1 has been subdivided and holds 62 residential customers. Only one residential lot remains undeveloped.^[13]

9. Area 2 is located at the northwestern end of the City. Area 2 is further divided into two segments, 2A and 2B. Segment 2A is the Mississippi Heights Addition, located adjacent to Highway 2 and the Mississippi River. Segment 2A forms a triangle with Elinda Drive and properties along County Home Road as the legs (and U.S. Highway 2 the hypotenuse).^[14] Lake Country serves 10 residential customers in

Segment 2A. Those 10 customers have been added from the time that Segment 2A was platted in 1977. Segment 2A has 13 undeveloped lots.^[15] Lake Country's office, located at 2810 Elinda Drive, is located within Segment 2A. The City is not proposing to acquire Lake Country as a customer.^[16] Four other commercial customers located in Segment 2A are being acquired.^[17]

10. Segment 2B, known as the Remer-Deschepper Addition, lies north of Elinda Drive. The entire segment was platted for residential development in 1952. Lake Country serves 62 customers in Segment 2B. There are 21 undeveloped lots in Segment 2B, all south of Deschepper Drive. North of Deschepper Drive, most of the area is wooded and undeveloped. No development is planned within the next 10 years for the undeveloped portion of Segment 2B that lies north of Deschepper Drive.^[18] All of Area 2 has had two new housing starts in each of the years 2000, 2002, 2003 and 2004. One new housing start was begun in Area 2 in 2001.^[19]

11. The City's existing service area extends to its municipal boundaries prior to the annexation of Areas 1 and 2. The western border of Area 1 is the eastern border of the City's existing service area. The northeast corner of Area 2 reaches the northwest corner of the City's service area.^[20] The western boundary of Area 2 abuts the eastern municipal boundary of Cohasset.

Additional Factors Affecting Future Development

12. New construction in the City is likely to occur in locations other than the areas under consideration in this proceeding. Two new residential developments, Forest Hills and Pine Ridge Estates First Addition, have been created in the southwest portion of the City. Forest Hills has 52 residential lots and Pine Ridge Estates has 12 residential lots. Both developments have access to City utilities and are located near retail establishments and other amenities. In addition, the development of 40 residential lots on the site of a former middle school is planned within the next year.^[21]

13. Lake Country has forecast load growth on its Cohasset Circuit 3 as "moderately-high."^[22] Cohasset Circuit 3 serves Area 2, the Cohasset Industrial Park, and other areas east of Lake Country's Cohasset Substation. The causes of that load growth are identified as the proximity to the City and the new customers entering the industrial park.^[23]

14. Lake Country has forecast load growth on its Gunn Circuit 2 as "moderately-low."^[24] Gunn Circuit 2 serves Area 1 and other areas east of the City. The saturation of the existing development in that region is identified as the reason for the lower load growth.^[25]

Future Annexation Plans

15. The City has entered into an orderly annexation agreement with the Township. Every two years, a portion of the Township will be annexed into the City. By 2010, the Township will be entirely incorporated into the City. The annexation is being

conducted to afford equitable treatment to the area residents regarding municipal services.^[26]

Proposed Construction by Lake Country

16. Lake Country has a thirty-year long-range plan for providing electricity within its service area (covering 2004-2033).^[27] The long-range plan has a ten-year transition plan to address interim planning issues. No construction of distribution facilities is proposed within the next ten years that would affect the annexed areas.^[28] Lake Country is proposing to build a new substation, located south of Lake Pokegema in approximately 12 years.^[29] Lake Country did not address its own assessment of load growth on the two circuits serving the annexed areas.

Analysis of Service in the Annexed Areas

17. The parties acknowledge that Lake Country is serving Area 1 and most of Area 2 with electricity within the meaning of Minn. Stat. § 216B.44. Lake Country is entitled to compensation for loss of revenue from the existing customers in the annexed areas. The parties dispute whether Lake Country is serving the remaining portion of Area 2 since there are no customers on the property, there are no facilities installed on the property, the segment is wooded, and no development is anticipated in that portion of Area 2 within the next ten years.

18. Both parties have discussed the impact of the Minnesota Court of Appeals decision in *ITMO the Complaint by Kandiyohi Cooperative Electric Power Association*.^[30] In that matter, a municipal utility installed facilities to serve a customer in an annexed area. The municipal utility did not seek an adjustment in the service area that was assigned to a cooperative to obtain authority to serve that customer. The cooperative had a distribution line running adjacent to the annexed area, but no facilities providing electric service to individual customers within the annexed area.^[31] The cooperative filed a complaint with the Commission objecting to the action by the municipal utility. The PUC concluded that the cooperative “had facilities in place capable of adequately serving the annexed area.”^[32] On appeal, the Minnesota Court of Appeals held that the annexed area was capable of receiving service from the cooperative and the municipal utility would have to follow the procedure in Minn. Stat. § 216B.44 to obtain the right to serve that area.^[33]

19. Confusion has arisen as to the “receiving service” issue due to the difference in holdings between *Kandiyohi* and the issue decided in another case involving lost revenue from a bare ground acquisition. The City of Olivia annexed some of the service territory of the Renville-Sibley Cooperative including 38 existing customers and a bare ground parcel where Olivia proposed to construct an industrial park.^[34] The PUC awarded compensation for depreciated original costs, the loss of future revenue from existing customers, and integration expenses. The Commission did not include the loss of revenue from future customers, including customers from the industrial park (to be developed by Olivia), reasoning that the compensation for future

customers was unreasonable, since Olivia was bearing the risk of development in the bare ground area acquired.

20. The City has asserted that any bare ground area that has been annexed (or that could be annexed) should not be considered to be “receiving service” from the existing cooperative in whose service territory the bare ground is situated. This assertion relies upon cooperatives having been put on notice by the service area adjustment statute, adopted in 1974, which states that upon annexation by a municipality:

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.^[35]

21. The PUC’s burden has been to apply the statutory structure to the interrelationship between municipal utilities and cooperatives in a fashion which assures that adequate planning can be conducted, electric service can be reliably obtained, and unnecessary conflicts avoided. The holding in *Kandiyohi* reaffirms that any change of service area boundaries can only be done through the Commission’s application process. The holding also clarifies that the particular parcel need not have facilities installed, so long as electrical service is reasonably available from the cooperative. The PUC has subsequently reaffirmed this principle in the *People’s 498 Docket*.^[36] To hold otherwise would encourage a “land rush” mentality on the part of both cooperatives and municipal utilities, resulting in the installation of equipment to “stake a claim” on unoccupied parcels.^[37] Such a practice is wasteful and contrary to the sound resolution of service area disputes available through the PUC.

22. But the determination that an area is receiving service is merely the first hurdle in resolving the question of compensation for an acquired service area. Where, as here, the utility has facilities adjacent to the boundary of the acquired bare ground, the area is receiving service within the meaning of Minn. Stat. § 216B.44(a).

23. The second hurdle for receiving compensation for future customers on a bare ground acquisition is whether the cooperative has made investments in the vicinity that make an award necessary to avoid stranded investments. This was the basis for a recommendation (not yet resolved by the Commission) in a service area petition filed by the City of Buffalo.^[38] The ALJ in *Buffalo* applied the PUC’s analysis in *North Park* where the Commission stated:

It would be unfair to foreclose utilities from serving areas that they made investments to serve, without awarding compensation, just because the customers on whose behalf the investments were made are not yet present. The inequity is especially obvious in this case, where the developer building homes in the area had requested service from People’s before the City decided to serve it. Such a policy would also undermine the utilities’ confidence in service area stability, decreasing their

willingness to invest to meet the future needs of their service areas and jeopardizing the statutory goal of ensuring economical, efficient, and adequate electric service throughout the state.^[39]

24. In **Buffalo**, the ALJ examined the facilities installed by the cooperative on a granular level, comparing the number and density of the cooperative's installed facilities and on a wider level, examining investments made in the surrounding areas adjacent to the acquired service area and the service quality provided to the area.^[40] In this matter, there has been no suggestion that Lake Country lacks investment in the wider area or that service quality is lacking.^[41] The only remaining question is the number and density of facilities installed adjacent to the bare ground area being acquired.

25. The occupied portion of Area 2 (mostly located south of Deschepper Avenue) currently has 69 residential electric customers and four commercial customers. There are 21 open lots in the area already developed. The bare ground portion of Segment 2B (north of Deschepper Avenue) has been platted to the same density as the developed portion. The number and density of installed facilities supports the conclusion that Lake Country is not precluded from an award of revenue from future customers by the "investment to serve" criterion established in **North Park**.

26. Having concluded that Lake Country has made the appropriate investments to serve the bare ground area in Segment 2B, only the issue of what compensation is appropriate remains to be resolved. In this matter, no witness testified that development was likely in the bare ground area over the next ten years. As discussed more fully below, ten years is an appropriate period for assessing a compensation award. With no future customers identified in the bare ground portion of Segment 2B, no award of lost revenue for that portion of the service area needs to be made.

-

Compensation Period

27. An important factor for calculation of a lost revenue award is the term of years over which the award is to be made. The City asserts that a period of less than ten years is appropriate. Lake Country maintains that ten years, at a minimum, is the appropriate compensation period. Lake Country uses a ten-year transition planning period and a thirty-year long-range forecast. The Commission has held that ten years is the appropriate period in **Olivia I** and **North Park**.^[42] Awarding future net revenues from existing customers over a ten-year period is appropriate compensation to Lake Country for the loss of revenue from the customers in Areas 1 and 2.

Settled and Remaining Issues

28. The City and Lake Country have agreed on the amount of compensation required for the "original cost of the property, less depreciation" and "expenses resulting from integration of facilities, and other appropriate factors."^[43] The parties agreed that the original cost amount should be \$50,024, the integration compensation should be

zero, and the “other appropriate factors” is zero. The parties differ on how to appropriately calculate the “loss of revenue to the utility formerly serving the area”, both in identifying what customers should be included in the calculation and how the appropriate rate of compensation should be calculated.

Lake Country Compensation Calculation

29. Lake Country prepared an analysis of revenue and costs to propose a compensation amount for the City’s acquisition of Areas 1 and 2. The analysis was tailored to fit the compensation formula set out in **North Park**. The formula calculates gross revenue from the acquired areas and deducts costs avoided by the cooperative for not having to serve customers in the acquired territory. The result is a net award that can be paid in a lump sum or reduced to a mill rate. The mill rate would then be applied to actual kWh supplied to customers to arrive at a compensation amount.

30. The annual gross revenue from Areas 1 and 2 was originally calculated by Lake Country as \$142,228.^[44] This figure included \$2,696 in off-peak sales, \$1,951 for increased demand, and \$198 for an additional schedule 10 customer.^[45]

31. The Lake Country analysis used a system-wide average wholesale power cost of 42.291 mills per kWh.^[46] At that mill rate, the estimated annual wholesale cost of electricity to Areas 1 and 2 would be \$67,511.^[47] That figure was revised to account for the included off-peak sales and a “whole house” rate to arrive at a purchased power cost of \$69,104.^[48] Initially, Lake Country assessed avoided operations and maintenance costs (O&M) based on 62 customers. The O&M costs were recalculated using 141 customers.^[49] In accounting for depreciation costs, Lake Country applied a 30-year depreciation period to the capital cost of facilities and took 10 years of the 30-year figure as costs incurred.^[50]

32. In addition to the existing customer revenue and costs, Lake Country calculated loss of revenue and avoided costs for future customers. Lake Country estimated the total gross revenue over a ten-year period from future customers as \$126,129 and the avoided costs as \$83,004, resulting in a net loss of revenue of \$43,126. This net loss of revenue, reduced to present worth, equates to a mill rate of 32.4 per kWh.^[51]

33. Using the foregoing factors and revising some figures based on new information, Lake Country calculated the annual gross revenue from the existing customers in Areas 1 and 2 as \$135,425, avoided costs as \$84,526, and net revenue as \$50,598.^[52] The loss of revenue compensation divided by annual kWh consumed by the existing customers in Areas 1 and 2 results in a mill rate of 33.8. At the hearing, Lake Country identified the mill rates for compensation of lost revenue as 35.4 for existing customers and 32.4 for future customers.^[53]

City Compensation Calculation

34. The City also used the **North Park** formula for calculating a compensation amount. The City adjusted the cost of electricity to account for the classes of customers

served using a cost analysis prepared in 2000 by Lake Country. Since the residential wholesale rate is higher than the system-average wholesale rate, this adjustment increased the avoided cost figure (thereby reducing the ultimate compensation amount). The City added an average avoided facilities cost to account for the reduction of load on Lake Country's distribution system equivalent to the load removed from service to the acquired customers.^[54] The City used a slightly higher depreciation rate than Lake Country for calculating the depreciation cost.^[55]

35. The City agreed with the annual gross revenue figure of \$135,425 for existing customers.^[56] The avoided costs were calculated as \$112,043, and net revenue as \$23,382.^[57] With an estimated annual consumption of 1,506,478 kWh, the City's compensation rate using the **North Park** formula is 15.5 mills per kWh.^[58]

36. Lake Country objected to the use of the cost figures in the cost analysis completed in 2000. Lake Country identified several charges that it maintains are no longer costs incurred. The City pointed out that those charges were used to justify a rate increase in 2000 that is still in effect. Lake Country increased its rate again, effective January 1, 2004, due to increases in its costs.^[59] The record in this matter supports using class-based cost figures from 2000. There is no basis for using a system-wide average electricity cost, since that cost figure will significantly understate the avoided costs under the **North Park** formula.^[60]

37. In its calculations, Lake Country asserts that the costs of providing electricity to its customers are low, thereby supporting a compensation rate that is much larger than other comparable acquisitions. But the record demonstrates that Lake Country's costs are so high that two rate increases (2000 and 2004) were necessary. Due to the impact of costs on the **North Park** formula, the derived compensation rate should not greatly exceed other similar acquisitions. Since Lake Country increased rates to customers in 2004, and the reason given is the increased cost of service, the ALJ finds that Lake Country must be experiencing higher costs than the average cooperative. This conclusion supports a lower compensation award than that advanced by Lake Country.

Reasonableness of Compensation Calculations

38. The City asserts that the compensation calculation of Lake Country is flawed in particular items, and unreasonable in result. The unreasonableness in result is demonstrated, according to the City, by the comparison of the average system margin to the existing customer margin in Areas 1 and 2. Using Lake Country's figures, the City showed that the system average margin for Lake Country is 2.6%. The proposed compensation amount from Lake Country for the existing customers in Areas 1 and 2, over a ten-year period, reflects a margin of 40.4%.^[61]

39. Lake Country maintained that acquisition of portions of its service area could well be more costly, in the aggregate, than buying the entire cooperative. The City acknowledged that while some increase of margin over the system-wide average was reasonable, a 15 to 1 ratio was facially unreasonable.^[62] Lake Country has

provided no satisfactory explanation for the extreme disparity between the system average margin and the margin for its existing customers in two otherwise unremarkable residential areas.

40. The City performed the same margin calculation using its own figures for compensation. The City arrived at a ratio of 7.6 to 1 for the lost revenue margin compared to the system-wide average. This ratio was described as “more reasonable” by the City.^[63]

41. The disparate margin calculations raise questions whether: 1) customers in Areas 1 and 2 are being overcharged for electricity; or 2) Lake Country’s application of the **North Park** formula, used to calculate the loss of revenue from those customers, is flawed.^[64] There is no indication that the gross revenue figure is distorted or that the retail mill rates charged to customers in Areas 1 and 2 are out of the ordinary for Lake Country’s system. The disparity arises from Lake Country’s application of the formula to calculate the loss of revenue.

Future Customers

42. Lake Country asserted that the City “projected that between 15 and 20 customers would locate in [Area 2].”^[65] The City maintains that there is no such projection. The record reflects the historical rate of growth in Areas 1 and 2 over their entire existence. The “estimate [of] the addition of one or two dwellings per year in [Areas 1 and 2] over the next ten years,” is immediately followed by the qualifier that the estimate is “generous.”^[66] The City identified three new residential developments (two currently underway and one approved) that will add an additional 104 residential lots to the housing market in the City.^[67] These can be viewed as “competitors” to the acquired area. The City also noted that there has been a 2.66 percent decrease in the City’s population from 1990 to 2000.^[68] Lake Country’s estimate of 17 future customers in Areas 1 and 2 lacks any foundation independent of this testimony.^[69]

43. Areas 1 and 2 are likely to see no further growth over the next ten years. With a decrease in population over the prior decade and an additional 104 developable lots, the market for additional new development is likely to decline. No witness testified to any particular attribute that would make the vacant lots in Areas 1 and 2 more likely to be built upon than the developments identified in the record. Under these circumstances, the recent historical rate of development is not a reliable predictor of future development. In light of these facts, an award of zero as compensation for future customers is appropriate.^[70]

Adequate Compensation Calculation

44. The formula set out in **North Park** is designed to provide, through economic modeling, a mill rate that can be applied to future kWh sales to arrive at an adequate compensation amount.^[71] The need for the modeling arose from the circumstance that many (all, for some parcels) of the customers were not already in place. That circumstance is not present in this matter. In this matter, all of the

customers to be served over the next ten years are already present. Most of the facilities serving those customers have been in place for many years. In a mature service area, there is no need for modeling. The gross revenue to be derived from the area is a known quantity and the net revenue going to the cooperative is not subject to variable factors due to newly-served customers that must be arrived at through modeling.

45. The Department assembled a list of 19 service area settlements and 2 orders over the past 13 years.^[72] In seventeen settlements, the mill rate ranged from 5 to 10 mills, most of these compensating for a period of 10 years. The most frequent compensation rate was less than 10 mills for residential areas. One settlement (for a residential area) was for 15 mills for a 5-year period and another was for 25 mills for a 10-year period. The mill rates for the two Commission compensation orders were 13.7 and 11 mills. The 13.7 mill/kWh award was for a single, very large customer and relied explicitly on the formula in the **North Park** decision.^[73]

46. In addition to the **North Park** formula, another metric has been in use for many years to calculate adequate compensation for service area adjustments. That metric has been to multiply the gross revenue from the service area being acquired by two.^[74] The resulting amount is the compensation to be paid for the ten-year compensation period. For mature service areas, there are significant benefits to this gross revenue multiplier formula. The calculation is not open to disparate interpretations. There are no opportunities for “normalizing” costs in ways that distort the calculation. With certainty in the compensation calculation, fewer disputes will arise that require resolution from the Commission.

47. The **North Park** formula was derived to adequately compensate a cooperative when a newly developed parcel was annexed (and service rights acquired) by a municipality. The formula used the capital costs of the installed facilities to arrive at a proxy figure of net revenue. Cooperatives have now changed their policies to shift the calculation of costs in response to the formula.^[75] The effects of these policy changes has been to significantly increase the proposed compensation for lost revenue be paid by municipal utilities, as calculated by cooperatives using the **North Park** formula. This increase is not reflective of an actual change in the value of service areas being acquired when compared to similar residential areas acquired in other proceedings. The difference in the calculated result arises from the way in which the formula treats changes in cooperatives’ interpretation of their costs.

48. The City’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. Applying these costs through the **North Park** formula results in an annual lost revenue compensation of \$23,382, translating into a mill rate of 15.5.^[76]

49. Since the areas annexed by the City in this matter are already developed and not likely to see further growth, the gross revenue multiplier formula is also an appropriate mechanism to derive the appropriate compensation amount. The appropriate gross revenue figure is \$135,425.^[77] Doubling that amount would yield a

compensation amount of \$270,850. Using the City's calculation of avoided costs, the annual lost revenue compensation derived using the **North Park** formula is \$23,382.^[78] Applying that figure over a 10-year compensation period results in a loss of revenue award of \$233,820 (without adjusting for current value). Applying the gross revenue multiplier formula results in a lost revenue compensation award of \$270,850. Since Lake Country's retail rate is at the high end of rates throughout Minnesota, compensation from the gross revenue multiplier formula will necessarily fall at the high end of the range of approved rates.^[79] With a high retail rate there is little chance of awarding insufficient compensation to the cooperative for the annexed areas using the gross revenue multiplier formula.^[80] The similarity between the ten-year loss of revenue figure derived through the City's application of the **North Park** formula and that derived by the gross revenue multiplier formula lends further support to the City's approach to the calculation.^[81]

Affordability of Acquisition

50. The City's average retail electricity rate paid by customers is 60.1 mills per kWh.^[82] The mill rate that Lake Country proposed as compensation for its net loss of revenue is 34.5 mills per kWh.^[83] The City asserts that setting the rate of compensation at 62.9% of what is charged to City electric customers amounts to a *de facto* revocation of the City's statutory right to serve the areas that the City has annexed.^[84] This assertion is supported by holding in **Olivia I**, where the Commission stated:

The Commission will not set the acquisition price so high that the City cannot possibly benefit from its actions. Such an acquisition price would make it impossible for the City to exercise its legal right to acquire the service area and would render Minn. Stat. § 216B.44 (1984) meaningless in this case.^[85]

51. The City's statutory right to serve annexed areas is conditioned on the payment of adequate compensation. The Commission revisited its holding in **Olivia I** on rehearing and clarified that a municipal utility's inability to pay compensation is not a basis for reducing a compensation award.^[86] As discussed in the Findings above, the compensation rate proposed by Lake Country is unreasonable. The comparison between the City's retail rate and Lake Country's proposed compensation rate further supports the conclusion that the rate is unreasonable. The disparity between these rates lends further support to the conclusion that a lower compensation rate is appropriate. But the lack of affordability to the City does not constitute an independent statutory basis for rejecting Lake Country's proposed compensation rate.

Based upon the foregoing findings, the Administrative Law judge makes the following:

CONCLUSIONS

1. The Minnesota Public Utilities Commission and the Administrative Law Judge have jurisdiction over the subject matter of this proceeding pursuant to Minn. Stat. Ch. 216B and section 14.50.

2. Any of the foregoing Findings of Fact containing material that should be treated as a Conclusion is hereby adopted as a Conclusion.

3. The two areas identified for inclusion in the City's exclusive service territory have been annexed by the City and are now within the City's municipal boundary. By operation of Minn. Stat. § 216B.44, the City is entitled to acquire the annexed service territory, upon payment of appropriate compensation.

4. The City and Lake Country have agreed that the value of the preexisting facilities being acquired, less depreciation, is \$50,024.00. Lake Country should receive compensation in the agreed-upon amount.

5. The City and Lake Country have agreed that there is no compensation appropriate for integration costs caused by the service territory adjustment.

6. Compensation for some loss of revenue from the acquired areas is appropriate over a reasonable planning period. Lake Country uses a ten-year long-range forecasting period for making facilities construction decisions. Ten years is the appropriate period for loss of revenue compensation.

7. Loss of revenue compensation for existing customers is appropriate based on a net revenue calculation, or alternatively, using the gross revenue multiplier formula. The City has demonstrated that its method for calculating net revenue is more accurate than Lake Country's method for reflecting the actual gross revenue and costs incurred to provide electricity to the existing customers. The electricity sales to the existing customers, at a mill rate of 15.5, reflecting net revenue per kWh, results in an annual compensation award of \$23,382, taken over a period of ten years results in an award of \$233,820. That amount, after an adjustment to current value, is the appropriate compensation for the loss of revenue from existing customers.

8. Using the gross revenue multiplier formula, the loss of revenue compensation award would total \$270,850. This amount is an appropriate alternative for the loss of revenue from existing customers over ten years. The total derived by the gross revenue multiplier formula may be applied over ten years and adjusted to current value.

9. Based on the standards set out in the Commission decision in **North Park**, loss of revenue compensation for future customers is not appropriate in this matter. The record in this matter demonstrates that the factors affecting future development render unlikely the development of the remaining lots in Areas 1 and 2 within the next ten years. No witness suggested that any of the wooded parcels in Segment 2B would be developed within the next 10 years. Under these circumstances, an award of no compensation for the loss of revenue from future customers is appropriate.

10. The City and Lake Country have agreed that there is no compensation appropriate for other appropriate factors.

11. The record supports the proposed settlement of all the uncontested matters arrived at by the parties and that proposed settlement should be adopted.

Based upon the foregoing Findings and Conclusions, it is the recommendation of the Administrative Law Judge to the Public Utilities Commission that it issue the following:

ORDER

1. Lake Country is entitled to compensation for lost revenue from existing customers in the annexed service area for a period of ten years. Lake Country is not entitled to compensation for lost revenue from any possible future customers.

2. The compensation to be paid to Lake Country for lost revenue from existing customers in the annexed service area be calculated using either the **North Park** formula or the gross revenue multiplier formula, in the amounts identified in the foregoing Conclusions.

3. The compensation to be paid to Lake Country for preexisting facilities being acquired, less depreciation, is the amount of \$50,024.00, as agreed to by the parties. No compensation is to be paid to Lake Country for integration costs caused by the service territory adjustment or “other” factors, as agreed to by the parties.

Dated this 3rd day of January, 2005.

_____/s/ Allan W. Klein
ALLAN W. KLEIN
Administrative Law Judge

-
Reported: Colleen M. Sichko, R.P.R.
Shaddix & Associates
Two Volumes
-

MEMORANDUM

Two fundamental issues are addressed in this matter. One is how to determine when an area is “receiving service” as that term has come to be understood in service area adjustments. The other is how to calculate reasonable compensation.

This recommendation sets out a mechanism, based on statutory standards and prior Commission decisions, providing a roadmap for assessment of “bare ground” areas. The mechanism affords a degree of certainty in assessing the characteristics of a particular area when conducting the “receiving service” analysis. Utilities are likely to benefit from this greater certainty, allowing reasonable resolution of disputes and avoiding the expense of a proceeding before the Commission.

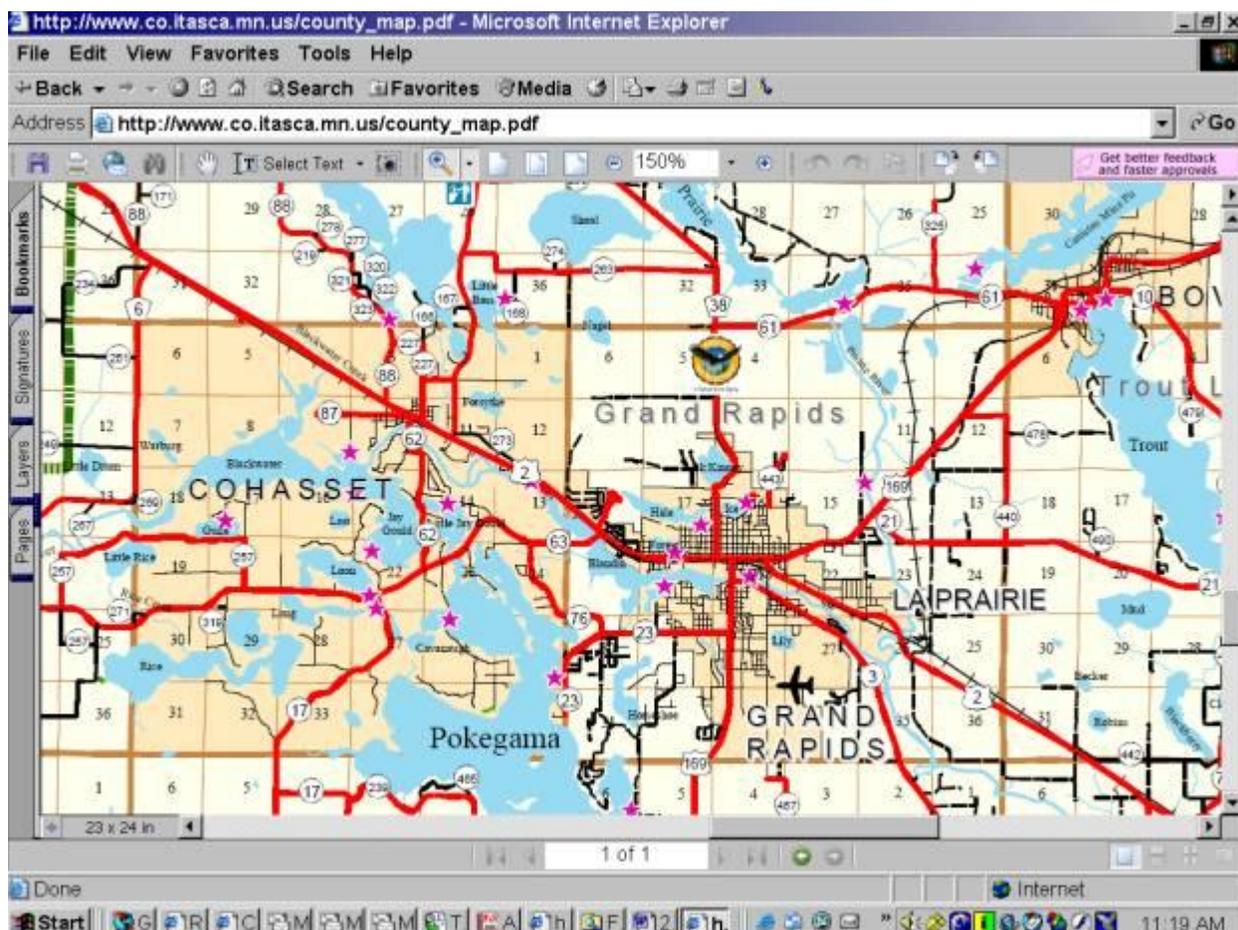
On its face, the statutory language addresses the circumstance where a municipality annexes a bare ground parcel without any electrical facilities in the vicinity. While no examples have been provided in the record of this proceeding, an award of compensation under such facts would be inappropriate, since the service provided by the municipality would relieve the cooperative of the burden of installing significant distribution facilities to reach the area and serve the new customers that will locate there. Where distribution facilities are near the annexed area, there is no such burden, therefore the area is deemed to be receiving service, even without installed facilities that would serve the future customer on the premises.

Similarly, an alternative has been proposed to more easily calculate the loss of revenue compensation to be paid to cooperatives. The record in this matter demonstrates that the straightforward formula set out in **North Park** is subject to wide swings in result, based on data that may be insufficiently transparent and insufficiently reliable. But in areas where future growth is not significant, using the gross revenue multiplier formula, affords both transparency and reliability. These characteristics are likely to be especially important to the two parties in this proceeding. Since the City is engaged in an orderly annexation process with the Township, these parties could be returning every two years for service area adjustments.

This Recommendation applies the facts in the record to two disparate formulae that have been used in calculating appropriate compensation. The dollar amounts from the two are quite similar. The ultimate decision regarding the compensation formula to be used is a matter of policy. That decision belongs to the Commission.

A.W.K.

Exhibit A
Map of Grand Rapids Area



(Map detail from Itasca County website, http://www.co.itsasca.mn.us/county_map.pdf)

[1] Ex. 20, Mattei Direct, at 2.

[2] See attached Exhibit A, Map of Grand Rapids Area.

[3] Ex. 20, Mattei Direct, at 8.

[4] All population figures are drawn from the 2000 census. For a description of how the population figures are broken down between the City, the Township, and La Prairie, see *Unprecedented Population Growth Revealed by Census* (J. Hibbs, Minnesota Planning, December 2001)(available online at:

<http://www.state.mn.us/ebranch/capm/census/publications/Unprecedented%20Pop%20Growth%20Reveal%20by%20Census%202000.pdf>). The Administrative Law Judge has taken notice of these data.

^[5] Ex. 20, Mattei Direct, at 8.

^[6] Ex. 17, Ward Direct, at 2. While GRPUC operates independently of the City Council, GRPUC is part of the City, and no distinction has been drawn between the two entities.

^[7] Ex. 17, Ward Direct, at 6.

^[8] Ex. 17, Ward Direct, at 6. The witness provided the figure in megawatt hours (MWH). One MWH is 1,000 kWh.

^[9] *Id.*, at 6. There is no explanation in the record for the substantial difference in per meter usage, with the City having a far higher usage per customer than does Lake Country.

^[10] Ex. 4, Seeling Rebuttal, RSS-1.

^[11] *Id.*

^[12] Ex. 22, Berg Direct, DAB-2.

^[13] Ex. 20, Mattei Direct, at 2.

^[14] Ex. 22, Berg Direct, DAB-2 at 2.

^[15] Ex. 20, Mattei Direct, at 2.

^[16] Ex. 22, Berg Direct, at 6.

^[17] Ex. 20, Mattei Direct, at 3.

^[18] Ex. 20, Mattei Direct, at 2-3.

^[19] Ex. 20, Mattei Direct, at 7.

^[20] Ex. 2, Eicher and Seeling Rebuttal, RSS-2, at 1.

^[21] Ex. 20, Mattei Direct, at 8.

^[22] Ex. 23, Berg Rebuttal, at 39.

^[23] *Id.*

^[24] Ex. 23, Berg Rebuttal, at 39.

^[25] *Id.*

^[26] Ex. 20, Mattei Direct, at 5; Ex. 17, Ward Direct, at 2.

^[27] Ex. 4, Seeling Rebuttal, at 4.

^[28] *Id.*

^[29] Ex. 4, Seeling Rebuttal, at 5.

^[30] ***ITMO the Complaint by Kandiyohi Cooperative Electric Power Association***, 455 N.W.2d 102 (Minn.App. 1990).

^[31] ***Kandiyohi***, at 103.

^[32] *Id.* at 103-104.

^[33] *Id.* at 104.

^[34] ***ITMO the Application of the City of Olivia to Extend its Municipal Electric Service Area into the Area Served by Renville-Sibley Cooperative Power Association***, E-288, 136/SA-85-93 (Order Setting Compensation, June 27, 1986)(*Olivia I*) and (Order after Rehearing, October 1, 1986)(*Olivia II*).

^[35] Minn. Stat. § 216B.44(a).

^[36] ***ITMO the Applicant by the City of Rochester for an Adjustment of its Service Boundaries with People's Cooperative Power Association***, Docket No. E-2999, 132/SA-93-498 (November 30, 1995)(*People's 498 Docket*). The Commission stated:

“Having facilities in place capable of serving the area,” and similar phrases used in bare ground cases, are short hand methods of saying that utilities that intend to discharge their duty to serve an area and have taken reasonable steps consistent with that duty are entitled to compensation. They do not have to show that they have in place the facilities and capacity to serve the area for the entire compensation period. ***People's 498 Docket***, at 9-10.

^[37] The Commission has held that facilities installed to inflate a compensation claim are not compensable. See ***ITMO the Complaint Regarding the Annexation of a Portion of the Service Territory of People's Cooperative Power Association by the City of Rochester (North Park Additions)***, E-132, 299/SA-88-270 (Order Determining Compensation, July 11, 1990)(“***North Park***”) at 9, fn. 5.

^[38] ***ITMO the Application of the City of Buffalo to Extend its Municipal Electric Service Area into the Area Presently Assigned to Wright Hennepin Cooperative Electric Association***, E221/SA-03-989 (ALJ Recommendation issued, October 26, 2004)(***Buffalo***).

^[39] ***North Park***, at 6-7.

[40] **Buffalo**, at 8-11.

[41] The City indicated that it receives occasional calls regarding Lake Country service outages, but this is insufficient to demonstrate inadequate service. See Ex. 17, Ward Direct, at 6.

[42] **Olivia I, ITMO the Complaint Regarding the Annexation of a Portion of the Service Territory of People's Cooperative Power Association by the City of Rochester (North Park Additions)**, E-132, 299/SA-88-270 (Order Determining Compensation, July 11, 1990)(**North Park**).

[43] Minn. Stat. § 216B.44(b).

[44] The parties agreed to use 2002 figures, which conclude with 62 residential customers and 2 billings at rate 40 in Area 1. In Area 2, those figures have 69 residential customers, and 1 billing at rate 21, 6 at rate 40, 1 at rate 45, and 1 at rate 70. Ex. 1, Eicher Direct, at 20, DRE-5.

[45] Ex. 36, Lusti Rebuttal, DVL-5 (as corrected June 29, 2004); Ex..1, Eicher Direct, DRE-6.

[46] Ex..1, Eicher Direct, at 23.

[47] Ex. 1, Eicher Direct, DRE-6, at 2.

[48] Ex..3, Eicher Surrebuttal, DRE-6R2, at 5.

[49] Ex..3, Eicher Surrebuttal, DRE-6R2, at 8-10. The 141-customer figure is the total of the existing 134 customers and 17 future customers.

[50] The City also challenged Lake Country's investment of surplus funds and the rate of return received on those investments. The record does not demonstrate that Lake Country's treatment of these funds is in any way improper.

[51] Ex..3, Eicher Surrebuttal, DRE-9R2, at 1.

[52] Ex. 3, Eicher Surrebuttal, DRE-6R2, at 2.

[53] Tr. Vol. I, at 124.

[54] Tr. Vol. II, at 253-258.

[55] At the hearing, the City asserted that the depreciation expense should be applied over a ten-year period to match the compensation period. If this is done, the expense for depreciation will be fully recognized within the compensation period, increasing the recognized cost and reducing the compensation award. The City's expert did not adopt this position at the hearing. The City's expert calculated the depreciation cost for using ten years of a thirty-year period. Tr. Vol. II, at 261-262.

[56] Tr. Vol. II, at 195.

[57] Ex..24, Berg Surrebuttal, DAB-1, at 2 (with corrections from the hearing noted).

[58] *Id.*

[59] Tr. Vol. II, at 305; Ex. 24, Berg Surrebuttal, DAB-1, at 19.

[60] The parties also disputed the load factor used by Lake Country to arrive at the cost. Tr. Vol. I, at 58-60. Since the system-wide average approach has been rejected there is no need to analyze the load factor used to calculate Lake Country's figure.

[61] Ex. 23, Berg Rebuttal, at 32.

[62] Ex. 23, Berg Rebuttal, at 33.

[63] Ex. 23, Berg Rebuttal, at 33.

[64] See, e.g. Tr. Vol. II, at 228-229.

[65] Lake Country Reply Brief, at 1-2.

[66] Ex. 20, Mattei Rebuttal, at 8.

[67] *Id.*

[68] *Id.*

[69] Ex. 3, Eicher Surrebuttal DRE-12 (identifying 16 future customers over 10 years); Tr. Vol. I, at 138.

[70] In the event that the Commission concludes that an award of compensation for future customers is appropriate, the record supports a maximum of sixteen new customers, at a rate of one or two per year. Since the lots are already being served by distribution facilities of long vintage, the mill rate for existing customers, applied to kWh actually purchased by these customers, is a suitable compensation mechanism, should the Commission determine that such compensation is warranted. See Tr. Vol. II, at 260-261.

[71] **North Park**, at 11.

[72] Ex. 35, Lusti Rebuttal, DVL-4.

[73] **ITMO the Petition by the City of Rochester for Approval of an Adjustment of its Service Territory Boundaries with People's Cooperative Services, Inc. (Celestica Property)**, PUC Docket No. E-132,299/SA-02-496 (Order Determining Compensation issued June 19, 2003)(**Celestica**). The cooperative asserted that a mill rate of 24 kWh was appropriate in **Celestica**. The cooperative

maintained that its rate schedule was the proper basis for calculating compensation, rather than the actual cost to the cooperative. Rochester argued that the cooperative would require construction of additional distribution circuits, requiring higher expense deductions in the net revenue calculation due to a system-wide avoidance of additional costs. The Commission concluded that the cost of service was the correct approach, and that the need for additional distribution equipment had not been shown. **Celestica**, at 7.

^[74] Tr. Vol. 1, at 113; see *also* Ex. 29.

^[75] An example of this practice is the use of contribution in aid of construction (CIAC). CIAC is the practice of requiring the customer to pay a significant portion of the facility installation charge. Adjusting for CIAC under the **North Park** formula was identified as a windfall to the cooperative by the ALJ in **Buffalo**.

^[76] Ex. 24, Berg Surrebuttal, DAB-1, at 2 (as revised).

^[77] Tr. Vol. II, at 195.

^[78] Ex..24, Berg Surrebuttal, DAB-1, at 2 (as revised).

^[79] See Tr. Vol. II, at 280-281.

^[80] The margin above the compensation derived from the **North Park** formula supports the conclusion that revenue from any potential future customers is included in the loss of revenue award.

^[81] By contrast, Lake Country's loss of revenue calculation, before adjusting to present value, is \$533,814. Ex. 3, Eicher Surrebuttal, DRE-6R2, at 1

^[82] Ex. 23, Berg Rebuttal, at 34.

^[83] Ex. 3, Eicher Surrebuttal, DRE-6R2, at 1.

^[84] Ex. 23, Berg Rebuttal, at 34.

^[85] **Olivia I**, at 13.

^[86] **Olivia II**.