STUDENT NOTE

ALIVE AND WELL; THE RURAL ELECTRIFICATION ACT PREEMPTS STATE CONDEMNATION LAW: *CITY OF MORGAN CITY V. SOUTH LOUISIANA ELECTRIC COOPERATIVE ASS'N**

I. INTRODUCTION

The electrification of rural America is undoubtedly one of the most significant accomplishments of a federal bureaucracy more often noted for its failures than its successes. The key instrument in this endeavor has been the Rural Electrification Act (REAct).[1] At the time of the REAct's enactment, a mere eleven percent of the nation's rural population received central station electrical service.[2] Today, as a result of Rural Electrification Administration (REA or Administration) loan programs and technical expertise, that figure approaches ninety-nine percent.[3]

It is because the rural electrification program has achieved such a measure of success[4] that many now call for the REAct's dismantlement, citing the statute's lack of necessity[5] and the imposition of growing financial burdens upon U.S. taxpayers as a result of interest subsidies favoring[6] and

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1. Ch. 432, 49 Stat. 1363 (1936) (codified as amended at 7 U.S.C. §§ 901-950 (1994)).

2. JOHN D. GARWOOD & W.C. TUTHILL, AMERICAN ENTER. INST. FOR PUB. POLICY RESEARCH, THE RURAL ELECTRIFICATION ADMINISTRATION: AN EVALUATION 59 (1963).

3. AMERICAN ENTER. INST. FOR PUB. POLICY RESEARCH, LEGISLATIVE ANALYSES: FINANCING RURAL ELECTRIFICATION 7 (1984) [hereinafter *Financing Rural Electrification*]. The actual figure reported is 98.7%. *Id.* For a detailed account of early Rural Electrification Administration history, see PHILIP J. FUNIGIELLO, TOWARD A NATIONAL POWER POLICY: THE NEW DEAL AND THE ELECTRIC UTILITY INDUSTRY, 1933-1941 (1973).

4. For a recent appraisal of various federal rural development programs, see Donald E. Voth, *A Brief History and Assessment of Federal Rural Development Programs and Policies*, 25 MEMPHIS L. REV. 1265 (1995).

5. *See generally* John Simpson, *Co-ops Battle Clinton Plan to Cut REA Loan Program*, PUB. UTILS. FORT., May 1, 1993, at 41.

6. On May 15, 1995, Senator Alan Simpson (R-WY) introduced S. 805, a bill designed to reform the current rural electrification program. S. 805, 104th Cong., 1st Sess. (1995). Criticizing current RUS, *see infra* notes 10-11 and accompanying text, lending practices, Sen. Simpson stated:

> Many areas of our country which are no longer rural are still being served by Government-subsidized utilities, even though commercial utilities are willing to provide that service. . . . We end up with a policy that subsidizes one competitor over another and we

increasingly-frequent loan defaults by cooperative borrowers.[7] In spite of any perceived need for its repeal, the REAct still enjoys the federal power of preemption. As *City of Morgan City v. South Louisiana Electric Cooperative Ass'n (Morgan City)*[8] illustrates, the REAct thus remains a legal force to be reckoned with.

It is the author's contention that Congress neither intended nor anticipated the REAct's use in preemption of state condemnation law in the manner permitted in *Morgan City*. The Fifth Circuit Court of Appeals, in a direct affront to legislative intent, has created a far-reaching and dangerous precedent favoring unwarranted interference with the most fundamental of states' rights. The resulting constraints placed upon states and their municipalities will inevitably retard the latter's capacity—dependent upon the ability to provide that full range of services necessary to promote growth and attract investment—for self-determination.

Part II of this Note examines the REAct and the federal government's role in bringing electricity to the nation's rural communities. In addition, current rural electrification program financing mechanisms are surveyed. Part III outlines the Fifth Circuit Court of Appeals' recent ruling in *Morgan City* and the reasons advanced for prohibiting municipal condemnation of an REA cooperative's property and service area in such circumstances. Lastly, Part IV analyzes the Fifth Circuit's decision and reviews the current state of the municipalization of cooperative assets issue.

II. THE RURAL ELECTRIFICATION ACT

A. *History*

Enacted in 1936, the REAct began as an effort to fill the void left by private utilities which saw the nation's farm communities as incapable of yielding the profits necessary to satisfy investors and thereby justify service.[9] The REAct established the REA—now the Rural Utilities Service[10]

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charge the bill to the taxpayers. That terrible market distortion is the product of an outdated rural electric policy that must be changed.

141 CONG. REC. S6691-92 (daily ed. May 15, 1995) (statement of Sen. Simpson).

7. *See, e.g.*, Richard P. Keck, *Reevaluating the Rural Electrification Administration: A New Deal for the Taxpayer*, 16 ENVTL. L. 39, 87-89 (1985). For a discussion of the economic woes experienced by one particular rural electric cooperative, see *Illinois Co-op to Pay Off $28 Million REA Debt at 50 Cents to the Dollar*, ELEC. UTIL. WK., May 23, 1994, at 15. *See also REA Asks TVA to Help Stranded Co-ops and Consider Purchase of Big Rivers*, ELEC. UTIL. WK., Aug. 1, 1994, at 8; *NRECA to Oppose Distribution Co-op Guarantees of REA Loans to G&Ts*, ELEC. UTIL. WK., Mar. 5, 1990, at 7; *N.H. Electric Co-op Emerges From Chapter 11 Bankruptcy*, ELEC. UTIL. WK., Dec. 6, 1993, at 3; *Vermont Co-op Wins Time to Reach a New Debt Restructuring Plan*, ELEC. UTIL. WK., Feb. 14, 1994, at 7.

8. 31 F.3d 319 (5th Cir. 1994), *reh'g denied*, 49 F.3d 1074 (5th Cir. 1995), *cert. denied*, 64 U.S.L.W. 3248 (U.S. Oct. 2, 1995) (No. 94-2135), *accord*, City of Stilwell, Oklahoma v. Ozarks Rural Elec. Coop. Corp., 870 F. Supp. 1025 (E.D. Okla. 1994).

9. Keck, *supra* note 7, at 42.

10. Ronald D. Jones et al., *Energy*, 1 ENERGY LAW AND TRANSACTIONS § 2.04[5] (David J. Muchow & William A. Mogel eds., 1995). "Section 302 of the Department of Agriculture Reorganization Act of 1994, P.L. 103-354, created the Rural Utilities Service with jurisdiction over the rural electric, telephone, waste, and water programs formerly under REA and the Farmers Home Administration." *Id.* at n.28.2.

(RUS or Service)[11]—as an independent agency empowered to make direct loans of Treasury funds.[12] The Government's average cost of borrowing was to determine the rate of interest affixed to such loans.[13]

Despite attractive lending rates, the exacting terms imposed on borrowers deterred private utilities from utilizing REA loans to expand their service areas to rural communities.[14] As a result, the REA began to urge rural residents to form cooperatives—private, non-profit membership corporations organized under state law[15]—for the purpose of supplying members with central station power.[16] Borrowed Administration funds provided these rural electric cooperatives (RECs or Cooperatives) with the large amounts of capital required for such projects.[17]

Being the only element of electrical service which was more costly to provide in rural areas than in non-rural ones, electricity distribution had been the primary deterrent to investor-owned utility service of provincial communities.[18] The construction and operation of such systems was thus the purpose for which RECs were initially formed.[19] These distribution cooperatives (DISCOs) were the original REA borrowers, laying claim to the vast majority of Administration loans for several decades.[20] As a result, the REA (RUS) has historically taken an active role in regulating and nurturing their operations.[21]

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11. For the sake of both readability and historical accuracy, the acronym "RUS" and the word "Service" are interposed in the text and footnotes only where contextually warranted.

12. Keck, *supra* note 7, at 45. The REAct, while having this effect, did not create the REA. The REA was established on May 11, 1935—roughly one year prior to enactment of the REAct— as an employment relief agency. Exec. Order No. 7037 (uncodified). The REA was charged with disbursing $100 million in federal funds made available for rural electrification through the Emergency Relief Appropriation Act of 1935, ch. 48, 49 Stat. 115 (1935) (expired by its terms in 1937), an unemployment relief package. Keck, *supra* note 7, at 44. This money was made available in the form of loans and grants. *See* S. REP. NO. 545, 98th Cong., 2d Sess. 5 (1984), *reprinted in* 1984 U.S.C.C.A.N. 575, 580-81.

13. Rural Electrification Act, ch. 432, § 4, 49 Stat. 1363, 1365 (1936) (amended to a fixed rate of 2% in 1944). The interest rate on REA loans averaged approximately 3%. *See* FUNIGIELLO, *supra* note 3, at 152-53.

14. FUNIGIELLO, *supra* note 3, at 153.

15. Keck, *supra* note 7, at 46. For an examination of cooperatives and their function, see ISRAEL PACKELL, ORGANIZATION AND OPERATION OF COOPERATIVES (4th ed. 1970), THE LAW OF THE ORGANIZATION OF COOPERATIVES (1940). *See also* HOWARD L. OLECK, NONPROFIT CORPORATIONS, ORGANIZATIONS AND ASSOCIATIONS (4th ed. 1980); LEMUEL ABRAHAMSEN, COOPERATIVE BUSINESS ENTERPRISE (1976); RAY F. MARSHALL ET AL., COOPERATIVES AND RURAL POVERTY IN THE SOUTH (1971); JOSEPH G. KNAPP, THE RISE OF AMERICAN COOPERATIVE ENTERPRISE 1620-1920 (1969).

16. THE TWENTIETH CENTURY FUND, THE POWER INDUSTRY AND THE PUBLIC INTEREST 125 (1944) [hereinafter *The Power Industry*].

17. *Id.*

18. *See* Gerald Pike, *Distribution Cost of Energy with Special Reference to Residence and Rural Customer*, *in* WHAT ELECTRICITY COSTS: A SYMPOSIUM ON THE COSTS OF DISTRIBUTION TO DOMESTIC AND RURAL CUSTOMERS 85-86 (Martin Cooke ed., 1933) ("density—the number of customers per mile of street—tends to decrease [electricity distribution costs] since the length of wire needed to reach the customers is lessened and since the average size of line transformers is increased and hence their unit cost is lessened").

19. *See The Power Industry*, *supra* note 16, at 125.

20. *See The Power Industry*, *supra* note 16, at 125.

21. DEPARTMENT OF AGRIC. TASK FORCE, EXECUTIVE COMM., PRESIDENT'S PRIVATE SECTOR SURVEY ON COST CONTROL: REPORT ON THE DEPARTMENT OF AGRICULTURE 283-85 (1983).

In addition to funding rural power distribution systems, the REA (RUS) is authorized to loan federal monies for the construction of generation and transmission facilities (G&Ts).[22] During the Administration's formative years, REA borrowers nevertheless purchased most of their power from either private utilities or federal power projects.[23] However, as the integrity of the rural power distribution network improved, loans for the construction of G&Ts increased markedly.[24]

Due to the capital-intensive nature of G&T construction, DISCOs desiring to produce their own power typically demand that their members enter into "all-requirements" contracts to assure the venture's success.[25] Under such contracts, these member distribution cooperatives agree to purchase all of their power requirements from the common G&T.[26] Accordingly, the G&T agrees to generate and transmit to each member the extent of its power needs.[27] This arrangement guarantees the G&T a steady influx of funds, thereby allowing the facility to cover its costs and service its debt, while at the same time providing member distribution cooperatives a reliable and inexpensive source of power.[28] Today, most RECs have come

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22. Rural Electrification Act, ch. 432, § 4, 49 Stat. 1363, 1365 (1926) (codified as amended at 7 U.S.C. § 904 (1994)) (stating that the REA (RUS) is authorized "to make loans . . . for the purpose of financing the construction and operation of generating plants, [and] electric transmission . . . lines or systems . . . .").

23. COMPTROLLER GENERAL, GENERAL ACCOUNTING OFFICE, REPORT TO THE CONGRESS-FINANCING RURAL ELECTRIC GENERATING FACILITIES: A LARGE AND GROWING ACTIVITY 7 (1980) [hereinafter *Financing Rural Electric Generating Facilities*]. One source notes:

> The first REA Administrator represented to the Congress that in 99 out of 100 instances rural electric systems would purchase wholesale electric supplies from existing power-generating plants. Strict guidelines were set on the circumstances under which loan funds could be used to build generating capacity. From 1935 through fiscal year 1941 only about 3 percent of all loan funds were devoted to the generation and to the wholesale transmission of power as distinguished from the building of distribution systems.

Financing Rural Electrification, *supra* note 3, at 3.

24. *See* GARWOOD & TUTHILL, *supra* note 2, at 15, 46. By 1982, approximately 85% of annual REA financing was reserved for generation and transmission facilities. CONGRESSIONAL BUDGET OFFICE, NEW APPROACHES TO THE BUDGETARY TREATMENT OF FEDERAL CREDIT ASSISTANCE 34, 36 (1984).

25. "Because all-requirements contracts allow the REA and the financial market to view G&Ts and their member distribution cooperatives as an integrated whole, reasonable and necessary financing can be made available to G&Ts despite the small equity margin." Tri-State Generation & Transmission Ass'n v. Shoshone River Power, Inc., 874 F.2d 1346, 1349 n.3 (10th Cir. 1989). For an analysis of equity financing of cooperatives, see Steve F. Brault, *Equity Financing of Cooperatives: Advantageous Federal Securities Law and Tax Treatment*, 21 WILLAMETTE L. REV. 225 (1985). *But see High Equity and Margins, Once Healthy, Now A Hazard, Co-op Leaders Warned*, ELEC. UTIL. WK., Oct. 10, 1994, at 5.

"The purpose of [all-requirements contracts] is to assure that the [G&T] will have a market for the power generated and transmitted by the REA-financed facilities and thus be able to repay [its] loan[s]." Alabama Power Co. v. Alabama Elec. Coop., 394 F.2d 672, 673 (5th Cir. 1968).

26. *Morgan City*, 31 F.3d at 323.

27. *Id.*

28. *Id.* The REA recently attempted to establish regulations requiring DISCO members to guarantee 50% of all future REA loans made to their G&T. *See NRECA to Oppose Distribution Co-op Guarantees of REA Loans to G&Ts*, ELEC. UTIL. WK., Mar. 5, 1990, at 7 (quoting a National Rural Electric Cooperative Association (NRECA) resolution which stated, "The proposal to seek direct mortgage involvement of distribution systems in G&T loans will have disruptive and uncertain effects

full circle and engage not only in the distribution of power, but also in its generation and transmission.[29]

B. Financing Rural Electrification

Prior to 1972, the REA pursued a policy of financing rural electrification through direct loans to cooperatives.[30] Though initially set in accordance with the Government's average cost of borrowing,[31] the interest rate attached to such loans had been fixed by statute at two percent in 1944.[32] In an effort to remedy what had over time developed into a federal subsidy favoring REA borrowers,[33] the Nixon Administration suspended the issuance of direct loans by the REA, refusing to disburse those funds already appropriated by Congress for that purpose.[34]

With the 1973 amendments to the REAct,[35] Congress sought to discourgage rural electrification borrowers from reliance upon REA lending.[36] The amendments also codified a departure from the previously standard practice of issuing direct loans.[37] Specifically, a funding policy was adopted whereby the REA would finance electricity distribution and

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upon rural electric system financing by confusing the security offered by the all-requirements contract").

29. *See Financing Rural Electric Generating Facilities*, *supra* note 23, at 7.

30. *See* Keck, *supra* note 7, at 49.

31. Keck, *supra* note 7, at 45. At the time of the REAct's enactment, the Government's cost of borrowing averaged 2-3%. Keck, *supra* note 7, at 45.

32. *Financing Rural Electrification*, *supra* note 3, at 2.

33. While an interest rate subsidy was never intended, the 2% interest rate nevertheless persisted as the sole direct loan rate for approximately thirty years. *Financing Rural Electrification*, *supra* note 3, at 2. Over this period, the federal government's average cost of borrowing rose to 5.099%, thereby resulting in a direct loan interest rate subsidy in excess of 3%. SYLVIA MORRISON, CONGRESSIONAL RESEARCH SERV., SOLVENCY OF THE RURAL ELECTRIC REVOLVING FUND: AN ECONOMIC ANALYSIS OF S. 1300 AND H.R. 3050, 98TH CONGRESS 10, 16 (1983), *reprinted in* H.R. REP. NO. 588, 98th Cong., 1st Sess. 84, 96, 102 (1983).

34. *See* H.R. REP. NO. 91, 93d Cong., 1st Sess. 4 (1973), *reprinted in* 1973 U.S.C.C.A.N. 1365, 1366-67.

35. Act of May 11, 1973, Pub. L. No. 93-32, 87 Stat. 65 (codified at 7 U.S.C. § 930 (1994)).

36. *Financing Rural Electrification*, *supra* note 3, at 5.

> The [1973 amendments to the REAct] stated that rural electrification . . . systems should be encouraged and assisted to develop their resources and ability to achieve the financial strength needed to enable them to satisfy their credit needs from their own financial organizations and other sources at reasonable rates and terms consistent with the loan applicant's ability to pay and achievement of the [A]ct's objectives.

Financing Rural Electrification, *supra* note 3, at 4.

37. This was done, in part, out of a desire to accomodate the Nixon Administration. *See* Note, *The Amended Rural Electrification Act: Congressional Response to Administration Impoundment*, 11 HARV. J. ON LEGIS. 205, 219 (1974). Nevertheless, one commentator points out:

> The REA *is currently authorized* to make direct loans from funds appropriated to the REA . . . . But no funds have been appropriated for REA direct loans since the Nixon Administration impounded the REA's funds in December 1972. Although Congress did not repeal the REA Administrator's authority to make such direct loans when it passed the 1973 legislation, the intention appears to have been to abandon the previous direct loan program. The Administrator's authority to make direct loans is thus in effect a dead letter.

Keck, *supra* note 7, at 51-52 (emphasis added).

power generation and transmission borrowers through insured loans and guaranteed loans respectively.[38] Insured loans were to carry an interest rate of five percent,[39] while the rate of interest associated with guaranteed loans was to fluctuate with the Government's average cost of borrowing.[40] To facilitate these new lending patterns, the Rural Electrification and Telephone Revolving Fund (Revolving Fund or Fund) was established.[41]

1. Insured Loans

The financing scheme implemented under the 1973 legislation reduced by half the number of REA borrowers eligible for two percent financing.[42] Modification in 1976 rendered only those borrowers most in need capable of obtaining the preferred rate.[43] Further legislation in 1981 placed within the REA's discretion the grant of financing at a rate less than five percent but not less than two percent.[44]

The Administration (Service) is authorized to issue insured loans from Revolving Fund assets.[45] These loans are excluded from federal budget totals and may not be circumscribed by general congressional limitations on expenditures and net lending.[46] Only legislatively-mandated program-specific limitations may have such an effect.[47] While such constraints have in fact been regularly imposed by Congress, so too have minimum annual lending levels.[48] Moreover, since the insured loan program was established

38. These new funding mechanisms were modeled after the 1972 Rural Development Act's, Pub. L. No. 101-624, 104 Stat. 4032 (1990), loan program. *See* Note, *supra* note 37, at 219.

39. *See* Act of May 11, 1973, Pub. L. No. 93-32, § 2(b), 87 Stat. 65, 69 (codified as amended at 7 U.S.C. § 935(b) (1994)).

40. CONGRESSIONAL BUDGET OFFICE, *supra* note 24, at 36.

41. *See* Act of May 11, 1973, Pub. L. No. 93-32, § 2, 87 Stat. 65 (pertinent parts codified at 7 U.S.C. §§ 931-935 (1994)). The Revolving Fund was established using $7.4 billion in outstanding REA direct loans made from 1953 to 1973, as well as certain other assets. *Financing Rural Electrification*, *supra* note 3, at 4. In 1976, an additional $455 million in capitalization was provided to reflect loans approved but not yet advanced prior to the Fund's creation in 1973. *Financing Rural Electrification*, *supra* note 3, at 4.

> The [R]evolving [F]und, which was to make all payments and receive all receipts applicable to the program, was expected to be self-sufficient except for sums that might later be appropriated to cover interest-rate subsidies and loan losses. [The] REA could borrow for the [R]evolving [F]und from the Treasury on interim notes at interest rates fixed by the Treasury. The Treasury was directed to purchase REA loans to borrowers whose repayment was insured by the REA. All these activities, aside from explicit appropriations to the fund, were to be off budget.

Financing Rural Electrification, supra note 3, at 4.

42. H.R. REP. NO. 91, 93d Cong., 1st Sess. 7 (1973), *reprinted in* 1973 U.S.C.C.A.N. 1365, 1373.

43. *Financing Rural Electrification*, *supra* note 3, at 5.

44. *Financing Rural Electrification*, *supra* note 3, at 5. The current criteria for making insured loans at rates less than 5% are found in 7 U.S.C. § 935 (1994).

45. 7 U.S.C. § 935 (1994). Proceeds obtained from the sale of insured loans are returned to the Revolving Fund. 7 U.S.C. § 931(a)(1), (3) (1994). *See* Note, *supra* note 37, at 225.

46. 7 U.S.C. § 935 (1994).

47. *Id.*

48. MORRISON, *supra* note 33, at 101.

in 1973, Congress has consistently set maximum, and often minimum, loan levels that have exceeded Revolving Fund income.[49]

With the 1973 establishment of the Federal Financing Bank (FFB), the REA (RUS) acquired an alternative means by which to generate funds for the financing of rural electrification.[50] Specifically, the Administration (Service) has the option of selling to the FFB certificates of beneficial ownership (CBOs or Certificates).[51] CBOs are a unique type of bond used by Government lending agencies to borrow from the FFB.[52] When issued by the REA (RUS), these certificates represent aggregations of outstanding Administration (Service) loans and thus give their holder an interest in the assets of the Revolving Fund.[53] Their sale is most often used to alleviate cash flow problems with the Fund.[54] Proceeds are deposited into the Revolving Fund, thereby enhancing the REA's (RUS's) ability to insure and guarantee rural electrification loans.[55]

2. Guaranteed Loans

Providing loan guarantees on behalf of cooperatives was one method by which the REA sought to reduce borrower requests for Administration financing.[56] Because a Government guarantee eliminates any risk of default, this approach normally enables a cooperative to obtain more favorable terms from a private lender than would otherwise be the case.[57] However, the practice of backing cooperative borrowing has not shifted the extension of credit directly to the private sector.[58] Rather, with the REA (RUS) as guarantor, the FFB also makes rural electrification loans.[59] When these guaranteed loans are converted into direct loans financed by the FFB through Treasury borrowing, cooperatives are able to obtain an even better rate of interest.[60]

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49. MORRISON, *supra* note 33, at 101.

50. *See Financing Rural Electrification*, *supra* note 3, at 5.

51. CONGRESSIONAL BUDGET OFFICE, *supra* note 24, at 39.

52. *Financing Rural Electrification*, *supra* note 3, at 5.

53. *See* Keck, *supra* note 7, at 53.

54. *Financing Rural Electrification*, *supra* note 3, at 5.

55. *See* Keck, *supra* note 7, at 53.

56. *See Financing Rural Electrification*, *supra* note 3, at 6.

57. *Financing Rural Electrification*, *supra* note 3, at 6.

58. *Financing Rural Electrification*, *supra* note 3, at 6.

59. Keck, *supra* note 7, at 55. Section 306 of the REAct makes it clear that FFB financing is at the borrower's discretion. *See* 7 U.S.C. § 936 (1994). Once a borrower obtains an REA (RUS) guarantee, the FFB is obligated to approve that borrower's loan request. Keck, *supra* note 7, at 55.

The primary difference between insured loans and guaranteed loans is that the latter are made by the FFB, not the REA (RUS) (although the Administration (Service) does serve as guarantor). Keck, *supra* note 7, at 55. One other notable difference is the higher rate of interest charged for guaranteed loans; the FFB makes REA (RUS) guaranteed loans at an interest rate one-eighth of one percent above the Treasury's cost of borrowing. Keck, *supra* note 7, at 55.

60. *Hearings on the Honest Budgeting Act of 1983 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess. 8 (1983) (statement of Rudolph G. Penner, Director of the Congressional Budget Office (CBO)).

Somewhat related to the issue of REA (RUS) loan guarantees is the Administration's (Service's) ability to subordinate liens or mortgages held by it.[61] Subordination attenuates the REA's (RUS's) priority as a secured creditor and thus allows a cooperative to obtain additional financing from other lenders.[62] By exposing itself to greater risk on outstanding Administration (Service) loans, the REA (RUS) enables the rural electrification borrower to procure a second loan at a favorable rate of interest where the latter's "needs are beyond the resources made available for REA loans."[63]

III. STATEMENT OF THE CASE

A. *Background*

In January 1985, as part of an expansion plan, the city of Morgan City annexed a small suburban area.[64] This annexation brought within the city roughly 252 electricity consumers who were at that time served by South Louisiana Electric Cooperative Association (SLECA), a rural power cooperative financed by the federal government under the REAct.[65] Morgan City, which operates its own municipal utility,[66] then attempted to purchase all of SLECA's property in the area, including the cooperative's exclusive right to service the electricity consumers affected by the city's annexation.[67]

SLECA refused Morgan City's purchase offer, whereupon August 3, 1990 the city filed a petition for expropriation in the 16th Judicial District Court, Parish of St. Mary, seeking to condemn the cooperative's property and electric service rights in the annexed area.[68] Cajun Electric Power Cooperative (Cajun), SLECA's G&T and also an REA-financed cooperative, intervened as a party defendant.[69] Both SLECA and Cajun having

61. Keck, *supra* note 7, at 55 (citing section 306 of the REAct (codified at 7 U.S.C. § 936 (1994))).

62. Rural Electrification Act, § 306, 7 U.S.C. § 936 (1994).

63. H.R. REP. NO. 91, 93d Cong., 1st Sess. 9 (1973), *reprinted in* 1973 U.S.C.C.A.N. 1365, 1374.

64. *Morgan City*, 31 F.3d at 321.

65. *Id.*

66. At the time, the Louisiana Energy and Power Authority supplied bulk power to Morgan City's utility system, the latter selling electricity to its customers at a rate 15% below SLECA's. *Id.* at n.3.

67. City of Morgan City v. South La. Elec., 837 F. Supp. 194, 195 (W.D. La. 1993) (*Morgan City I*), *aff'd*, 31 F.3d 319 (5th Cir. 1994), *reh'g denied*, 49 F.3d 1074 (5th Cir. 1995), *cert. denied*, 64 U.S.L.W. 3248 (U.S. Oct. 2, 1995) (No. 94-2135), *accord*, City of Stilwell, Oklahoma v. Ozarks Rural Elec. Coop. Corp., 870 F. Supp. 1025 (E.D. Okla. 1994). Morgan City offered to pay a total of $895,955.78—$111,994.47 per year over an 8 year period—for SLECA's *facilities* (lines, poles, transformers, and related equipment). *Morgan City I*, 837 F. Supp. at 196.

68. *Id.* at 195.

69. *Id.* Plagued by financial difficulties, including costly investment in the River Bend nuclear power plant and conflicting Louisiana Public Service Commission and RUS rate orders, Cajun filed for Chapter 11 bankruptcy on December 21, 1994 in U.S. Bankruptcy Court, Baton Rouge, Louisiana. *Cajun, In Regulatory Squeeze, Seeks Chapter 11 Bankruptcy Protection*, ELEC. UTIL. WK., Dec. 26, 1994, at 1 (reporting that "[t]he Cajun bankruptcy is one of the largest defaults by a cooperative group since the [rural electrification program's inception]"). For further discussion of the problems facing the G&T, see *Morgan City Case Ruling Supports Claim on Cajun Co-Op Rates*, ELEC. UTIL. WK., Apr. 17, 1995, at 6. *See also Louisiana Asks Judge to Dismiss RUS Claims of Jurisdiction in Cajun Case*, ELEC. UTIL. WK., Mar. 27, 1995, at 3; *Judge Refuses to Halt Rate Decrease Ordered for Cajun by La. Regulators*, ELEC. UTIL. WK., Feb. 6, 1995, at 3; *La. PSC Acted on Purpose to Foist Cajun Costs on U.S.*

mortgaged their assets to the REA to secure their federal loans,[70] the United States was joined as a third party defendant on the basis that the federal government held a security interest in the property which was the subject of the proceeding.[71] The United States then removed the action to federal court.[72]

The district court for the Western District of Louisiana granted Defendants' motion to dismiss.[73] The court determined that to allow the proposed expropriation would be in direct contravention of the REA's stated purpose—rural electrification.[74] Specifically, section 907 of the REAct requires Administration approval of any expropriation as protection against alienation of the security—a cooperative's assets—upon which the REA premised federal loans.[75] If the Administrator concludes that such action poses a threat to the REA's security interest, he may decline approval.[76] To do otherwise would present an economic risk to the Administration and threaten its ability to facilitate rural electrification.[77] Because the Administrator refused approval of Morgan City's proposed expropriation only after extensive deliberation,[78] the court upheld the REA's decision under the "arbitrary and capricious" test, stating:

> [T]his court is not to revisit the merits of the argument presented to the REA[.] [R]ather[,] [it] is to review the administrative agency actions for procedural validity and under an arbitrary and capricious and/or abuse of discretion standard of review .... Upon review, the administrator's decision cannot be said to be arbitrary and capricious or an exercise of abuse of discretion, particularly given the value of the property to be expropriated versus the proposed payout, the selection of the City of the densest service population of SLECA for expropriation and the resultant negative impact on SLECA of the expropriation.[79]

Taxpayers, ELEC. UTIL. WK., Jan. 23, 1995, at 1; *Cajun, in Chapter 11, Seeking Ruling on State vs. Federal Rate Authority*, ELEC. UTIL. WK., Jan. 9, 1995, at 3.

70. *Morgan City*, 31 F.3d at 321. At the time of appeal from the district court's ruling, SLECA had obtained 25 REA-financed loans totalling over $38 million, $25 million of which was outstanding. *Id.* at n.1. Cajun had obtained $3 billion in similar loans. *Id.* at n.2.

71. *Morgan City I*, 837 F. Supp. at 195.

72. *Id.*

73. *Id.* at 200.

74. *Id.* at 198.

75. *Morgan City I*, 837 F. Supp. at 197. Section 907 provides:

> No borrower of funds under sections 904 or 922 of this title shall, without the approval of the Administrator, sell or dispose of its property, rights, or franchises, acquired under the provisions of this chapter, until any loan obtained from the Rural Electrification Administration, including all interest and charges, shall have been repaid.

7 U.S.C. § 907 (1994).

76. *Morgan City I*, 837 F. Supp. at 197.

77. *Id.* at 199-200.

78. The REA's decision was based upon an administrative record some 300 pages in length. *Id.* at 199. The decision itself took the form of a "28 page report with numerous attachments and studies" issued by the REA and detailing the basis of the Administrator's refusal to approve expropriation. *Id.* at 196.

The court noted, "[We] cannot ignore the potential of similar action by similarly[-]situated communities and the resultant destructive impact on the REA and its stated purpose." *Id.* at 198.

79. *Morgan City I*, 837 F. Supp. at 198 (citing 5 U.S.C. § 706 (1988)).

B. The Fifth Circuit Court of Appeals

The Fifth Circuit Court of Appeals affirmed the district court's dismissal of Morgan City's expropriation petition.[80] Noting its prerogative to affirm on bases other than those relied upon below,[81] the Court of Appeals skirted the question whether section 907 confers upon REA's Administrator the authority to withhold approval of an *involuntary* disposition of cooperative assets, stating "we save for another day [this] issue."[82] Rather, the court elected to apply the federal doctrine of conflict preemption to determine the propriety of the dismissal.[83]

Specifically, the Court of Appeals chose to employ the "frustration of federal purpose" doctrine, a particularized strain of conflict preemption.[84] The frustration of a federal purpose occurs when compliance with a provision of state law disturbs, interferes with, or seriously compromises the integrity of a federal statutory scheme.[85] This is true even if it is not impossible to observe both state and federal law.[86]

Acknowledging the elusiveness of this inquiry, the Court of Appeals cited *Hines v. Davidowitz*,[87] wherein the Supreme Court stated:

> [There exists no] infallible constitutional test or an exclusive constitutional yardstick [for determining whether a given application of state law will frustrate a federal purpose]. In the final analysis, there can be no one crystal clear distinctly marked formula. Our primary function is to determine whether, under the circumstances of th[e] particular case, [state] law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.[88]

The court nevertheless found guidance in the Ninth Circuit Court of Appeals' opinion in *PUD No. 1 of Pend Oreille County v. United States (Pend Oreille)*.[89]

In *Pend Oreille*, the Ninth Circuit held that a state municipal public utility was foreclosed from condemning REC-owned property since the condemnation would interfere with the federal purpose inherent in the

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80. *Morgan City*, 31 F.3d at 324. *See NRECA Sees Morgan City Case Crucial to Survival of Cooperative Program*, ELEC. UTIL. WK., Oct. 11, 1993, at 5 (discussing the NRECA's claim that "the case reaches the heart of the issue of REA's authority to block condemnations"). *See also Court Hits Municipals: Morgan City Cannot Condemn Co-op Service Area*, ELEC. UTIL. WK., Sept. 19, 1994, at 1; *Morgan City, Rebuffed by Court Panel, Seeks Rare Rehearing by Full Court*, ELEC. UTIL. WK., Oct. 3, 1994, at 10; *Court Denies Morgan City Rehearing Effort: APPA Considers Supreme Court*, ELEC. UTIL. WK., Apr. 10, 1995, at 10.

81. *See* United States v. Early, 27 F.3d 140, 142 (5th Cir. 1994) (holding that a court can affirm on alternative grounds).

82. *Morgan City*, 31 F.3d at 322.

83. *Id.*

84. *Id.*

85. Pacific Gas & Elec. Co. v. State Energy Resources Conservation & Dev. Comm'n, 461 U.S. 190, 204, 220-21 (1983).

86. *Id.* at 204.

87. *Morgan City*, 31 F.3d at 323.

88. Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

89. 417 F.2d 200 (9th Cir. 1969).

REAct.[90] The *Pend Oreille* court reasoned that even if compensated for under state law, the removal of a portion of the nation's rural electrification system would so weaken the remaining network as to lessen its ability to properly function, thereby undermining Congress's objective of providing reliable, low-cost electricity to rural America.[91] That court further opined:

> [W]hat is sought to be taken here is part of a system and even if the part taken is paid for, and if an award is made for the damage to the remaining portion, a question remains as to the capacity of the remaining portions of the system to function. . . . [I]f, as a result of the condemnation, the loans [used to finance the system] were paid in full, but the remaining portions of the system could not continue to operate with decent service and at decent rates, the Government would have been paid but the purpose of the Rural Electrification Act would have been frustrated.[92]

Relying upon *City of Madison v. Bear Creek Water Ass'n* (*Bear Creek*),[93] a Fifth Circuit decision which adhered closely to the *Pend Oreille* court's logic, the Court of Appeals recounted its refusal to sanction a municipal utility's proposed condemnation of a federally subsidized rural water utility.[94] Much like the Ninth Circuit in *Pend Oreille*, the Fifth Circuit therein concluded that such action, and the resulting loss of existing economies of scale, would contravene the federal purpose at work in the Consolidated Farm and Rural Development Act.[95]

Citing both *Bear Creek* and the fact that Morgan City had chosen for expropriation SLECA's most densely populated (and thus due to economies of scale its most profitable) service area, the Court of Appeals stated that the proposed condemnation would, as a matter of course, result in higher operating margins for SLECA.[96] These increased costs would inevitably be passed on to SLECA's remaining customers in the form of higher electricity rates.[97] The court found this outcome repugnant to the rural electrification program's objective of inexpensive power for rural residents.[98]

However, the court found a more serious consequence of any expropriation to be the destabilization of the entire rural electrification program itself.[99] This, the Court of Appeals held, was a possible result of alienating a cooperative's—such as SLECA's—most profitable customers, thus leaving it with insufficient revenue to repay its federally funded loans.[100] Noting evidence of planned future expropriations by Morgan City, in addition

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90. *Id.* at 201-02.
91. *Id.*
92. *Id.* at 201.
93. 816 F.2d 1057 (5th Cir. 1987).
94. *Morgan City*, 31 F.3d at 324.
95. *Bear Creek*, 816 F.2d at 1060 (citing PUD No. 1 of Franklin County v. Big Bend Elec. Coop., Inc., 618 F.2d 601 (9th Cir. 1980)).
96. *Morgan City*, 31 F.3d at 324.
97. *Id.*
98. *Id.*
99. *Id.*
100. *Morgan City*, 31 F.3d at 324.

to the one at issue, the court found this scenario not difficult to envision.[101] Concluding the record amply supported the REA Administrator's decision that the proposed condemnation would threaten the integrity of the rural electrification program, thereby frustrating the REAct's underlying federal purpose, the Court of Appeals affirmed the district court's dismissal of Morgan City's petition for expropriation.[102]

IV. ANALYSIS

A. *The Fifth Circuit's "Frustration of Purpose" Analysis*

1. Generally

The Fifth Circuit Court of Appeals' decision in *Morgan City* is problematic with respect to the court's expansion of the "frustration of federal purpose" preemption doctrine.[103] Any recognition of a federal purpose necessarily entails finding that Congress has "unmistakenly ordained" such.[104] To be sure, the REAct was enacted to facilitate rural electrification. Nevertheless, the Fifth Circuit's recognition of this broad congressional purpose[105] is an insufficient basis upon which to restrict a state's (in this case a municipality's) inherent authority to condemn property in the public interest,[106] an authority derived from the broadest and most discretionary of powers reserved to the states—the police power.[107] Any such

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101. *Id.* (stating "we do not consider this concern hypothetical in light of the evidence in the record of future proposed annexations in the Morgan City area, as well as the Houma, Louisiana area").

102. *Id.* (surmising "[w]ere Morgan City's expropriation action allowed to stand, it would 'stand as an obstacle' to the repayment of federal loans, to the financial viability of federally financed electricity cooperatives, and ultimately, to the maintenance of electricity service to rural areas" (quoting *Hines*, 312 U.S. at 67)).

103. On the subject of "frustration of federal purpose" preemption, see HON. KENNETH STARR ET AL., AMERICAN BAR ASS'N, THE LAW OF PREEMPTION: A REPORT OF THE APPELLATE JUDGES CONFERENCE 27-30, 36-38 (1991) (referring to the doctrine as "obstacle preemption" and noting that the particular method of analysis engendered thereby "demands a high degree of judicial policymaking"). *See also* Stephen A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 767 (1994); Richard J. Pierce, Jr., *Regulation, Deregulation, Federalism, and Administrative Law: Agency Power to Preempt State Regulation*, 46 U. PITT. L. REV. 607 (1985).

104. Petitioner's Supplemental Letter Brief at 3, *Morgan City* (No. 93-4295) (citing Florida Lime and Avacado Growers v. Paul, 373 U.S. 132, 142 (1963)).

105. *Morgan City*, 31 F.3d at 324 (stating " 'Congress has declared the federal purpose to electrify the American farm' " (quoting *Pend Oreille*, 417 F.2d at 202)).

106. Commonwealth Edison v. Montana, 453 U.S. 609, 633-34 (1981) (rejecting that general statements of national policy can demonstrate congressional intent to preempt state law that may have an adverse impact on attainment of the federal policy objective).

> "[P]re-emption of state law by federal statute or regulation is not favored 'in the absence of persuasive reasons—either that the nature of the regulated subject matter permits no other conclusion, or that the Congress has unmistakably so ordained.' " In cases such as this, it is necessary to look beyond general expressions of "national policy" . . . with which the state law is claimed to conflict.

Id. at 634 (citations omitted).

On the topics of the nature, origin, evolution and characteristics of the eminent domain power, see 1 JULIUS L. SACKMAN & RUSSELL D. VAN BRUNT, NICHOLS' THE LAW OF EMINENT DOMAIN (1995).

107. The police power is defined as "[t]he power of the State to place *restraints* on the personal freedom and *property rights* of persons for the protection of the public safety, health, and morals or the

constraint imposed upon the exercise of eminent domain—the quintessential local power—becomes more bothersome when one considers that any condemnation of REC assets obligates the acting municipality to remit just compensation.[108]

The linchpin of the Court of Appeals' determination that expropriation would frustrate the federal purpose of the REAct was the "fact" that Morgan City's proposed condemnation of SLECA's property and service area (and future ones like it) would threaten the financial integrity of both that cooperative and Cajun, its supplier of bulk power.[109] The fear was that resulting economic anemia would prevent one or both of these federally financed entities from honoring their loan obligations, possibly compromising the Administration's entire rural electrification program.[110] Despite the dispositive effect of this assumption,[111] the district court—and, as a result, the Court of Appeals—relied blindly upon the REA Administrator's report, which concluded that expropriation would impede realization of REAct objectives.[112] This was primarily due to the district court's willingness to accept as true the Administrator's conclusions on the issue of frustration of purpose,[113] notwithstanding the dubious nature of such reliance.[114] As a result, the court denied Morgan City discovery on that issue.[115] The district court further refused to entertain the city's existing

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promotion of the public convenience and general prosperity." BLACK'S LAW DICTIONARY 1041 (5th ed. 1979) (emphasis added). The police power is reserved to the states through the Tenth Amendment to the United States Constitution which reads, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X.

108. City of Morgan City v. South La. Elec. Coop. Ass'n, 49 F.3d 1074, 1076 (5th Cir. 1995) (denying rehearing) (Jones, J., dissenting), *cert. denied*, 64 U.S.L.W. 3248 (U.S. Oct. 2, 1995) (No. 94-2135). Fair compensation for the taking of private property is a requirement of the Fifth Amendment to the United States Constitution which provides: ". . . nor shall private property be taken for public use, without just compensation." U.S. CONST. amend. V. For a discussion of valuation of property taken through an exercise of eminent domain, see 1 LEWIS ORGEL, VALUATION UNDER THE LAW OF EMINENT DOMAIN § 42 (James C. Bonbright ed., 1953).

109. *Morgan City*, 31 F.3d at 324.

110. *Id.* (citing *Hines*, 312 U.S. at 67).

111. This was the premise underlying the Fifth Circuit's affirmation of the district court's dismissal of Morgan City's expropriation petition. *See id.* at 324.

112. *See id.*

113. *Morgan City I*, 837 F. Supp. at 199. "[T]he REA compiled a very thorough . . . record and granted an exhaustive decision in which it independently verified and analyzed the facts and logic underlying the submissions by various parties. . . . Therefore, this court finds that the . . . decision issued on behalf of the agency and approved by the [A]dministrator was [sound]." *Id.*

114. "[W]hether there is an actual conflict that 'frustrates the ability to repay REA-backed loans' raises a factual question. Yet no hearing or trial occurred here, despite conflicting affidavits of competent experts on both sides." *Morgan City*, 49 F.3d at 1078 (Jones, J., dissenting). Furthermore, "[l]etters by the administrator of the REA cannot suffice to ordain preemption." *Id.* at 1078 n.7 (citing Wabash Valley Power Ass'n v. REA, 903 F.2d 445, 453 (7th Cir. 1990)). *See also* Thomas v. New York, 802 F.2d 1443 (D.C. Cir. 1986) (Scalia, J.) (holding that a letter from the EPA Administrator does not have the force of law). "We have not found any case holding that a federal agency may preempt state law without either rulemaking or adjudication." *Id.*

115. Petitioner's Supplemental Letter Brief at 3, *Morgan City* (No. 93-4295).

evidence that expropriation would in fact not frustrate the federal purpose of the REAct.[116]

In affirming the district court's dismissal of Morgan City's petition, the Court of Appeals engaged in an unwarranted exercise of judicial activism. The Supreme Court has declared that "[d]eciding what competing values will or will not be sacrificed to the achievement of a particular objective is the very essence of legislative choice—and it frustrates rather than effectuates legislative intent simplistically to assume that whatever furthers [a] statute's primary objective must be the law."[117] At best, a federal court can effectuate a congressional policy decision, striking down state law to the extent it inhibits the same.[118] It cannot, however, determine legislative policy under the rubric of preemption analysis.[119]

Assuming *arguendo* the correctness of both the REA's analysis of the adverse impact expropriation would have on SLECA's financial health[120] and the Court of Appeals' determination that such a repercussion would threaten what it identified as the REAct's federal purpose (rural electrification), the court's ruling nevertheless remains disturbing. Specifically, it has been held that "[t]o the extent the REA believes that states must adopt rules of law that always allow federal lenders to recoup their investments, it is mistaken."[121] Even the REA's (RUS's) own regulations anticipate loss of borrower territory as a result of annexation and therefore require the Administrator to consider this contingency when issuing loans.[122] The

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116. *See id.*

117. Petitioner's Supplemental Letter Brief at 5, *Morgan City* (No. 93-4295) (quoting Rodriguez v. United States, 480 U.S. 522, 525-26 (1987)). *See also Pacific Gas & Elec. Co.*, 461 U.S. at 223 (discussing preemption analysis and stating "The courts should not assume the role which our system assigns to Congress").

118. Amici Curiae's Supplemental Brief at 8, *Morgan City* (No. 93-4295) (*Morgan City* amici included the American Public Power Association (APPA), the National League of Cities, and the National Institute of Municipal Law Officers).

119. *Id.*

120. Due to the district court's refusal to permit Morgan City discovery on this issue, in addition to its declination to rule on such opposing evidence as Plaintiff had available, the accuracy of the REA's calculations cannot be known. *See supra* text accompanying notes 115-16.

121. *Wabash Valley Power Ass'n*, 903 F.2d at 454 (citing United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979)). As the Supreme Court in *Kimbell Foods* observed:

> [Federal agencies] evaluate the risks associated with each loan, . . . choose the security believed necessary to assure repayment, and set the terms of every agreement. By carefully selecting loan recipients and tailoring each transaction with state law in mind, the agencies are fully capable of establishing terms that will secure repayment.
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> . . . [T]he United States believes that its security interests demand greater protection than ordinary commercial arrangements. We find this argument unconvincing. The lending agencies do not indiscriminately distribute public funds in the hope that reimbursement will follow. . . . [A]gencies have promulgated exhaustive instructions to ensure that loan recipients are financially reliable and to prevent improvident loans. The Government therefore is in substantially the same position as private lenders, and the special status it seeks is unnecessary to safeguard the public fisc.

440 U.S. at 736-37.

122. Specifically, 7 C.F.R. § 1710.112(b)(5) (1995) provides:

> (b) Based on evidence submitted by the borrower and other information, RUS will use the following criteria to evaluate loan feasibility:

Administration (Service) is expected to mitigate any such risk of loss by imposing offsetting conditions on rural electrification loans.[123]

2. *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Commission*

The Court of Appeals' *Morgan City* ruling ignores the mandate of the seminal piece of High Court jurisprudence on the issue of REAct "frustration of purpose" preemption of state law—*Arkansas Electric Cooperative Corp. v. Arkansas Public Service Commission* (*Arkansas Electric*).[124] In *Arkansas Electric*, the Supreme Court rejected an implied preemption argument similar to that relied upon by the Fifth Circuit in *Morgan City*.[125] Specifically, the High Court upheld a state's attempt to regulate the wholesale electricity rates of an REC situated within its borders.[126] In response to the REA's claim that this state regulation posed a threat to repayment of Administration loans, thereby compromising the REA's ability to finance rural electrification—i.e. its federal purpose, the Court replied that although the Administration was expected to assist cooperatives in setting rates at a level sufficient to allow loan repayment, "it [was to] do so within the constraints of existing state regulatory schemes."[127]

In support of its holding, the Court noted that REA policy required cooperatives to obtain approval of rates both from and in the manner prescribed by state regulatory authorities.[128] While acknowledging that the imposition upon RECs of certain state regulatory schemes might indeed undermine the federal government's security interest in loans made to those entities, the Court nevertheless observed: "The relevant inquiry, however, is not whether Congress authorized or expected such regulation, but whether it intended by its own actions to *forbid* it."[129] Just as they have historically regulated ratemaking, states have traditionally assigned electric utility service areas.[130]

. . . .

(5) *Risks of loss of portions of the borrower's service territory from annexation . . . will not substantially impair loan feasibility.* If there appears to be a substantial risk, RUS may require additional information from the borrower, such as a summary and analysis of the risk by the borrower; state, county or local planning reports having information on projected growth or expansion plans of local communities; annexation plans of the municipalities in question; and any other relevant information.

Id. (emphasis added).

123. *Wabash Valley Power Ass'n*, 903 F.2d at 453.

124. 461 U.S. 375 (1983).

125. *Id.* at 385-89.

126. *Id.* at 396.

127. *Id.* at 386. *See generally* Charles G. Stalon & Reinier H.J.H. Lock, *State-Federal Relations in the Economic Regulation of Energy*, 7 YALE J. ON REG. 427 (1990).

128. *Arkansas Electric*, 461 U.S. at 387-88.

129. *Id.* at 387 n.11 (emphasis in original).

130. Amici Curiae's Brief at 9, *Morgan City* (No. 93-4295) (stating "[r]egulation of utilities is, of course, 'one of the most important of the functions traditionally associated with the police power of the [s]tates' " (quoting *Arkansas Electric*, 461 U.S. at 377)).

B. *Municipalization—Economic Epidemic or Hypochondria?*[131]

1. The REA (RUS)/REC Perspective

The extent to which municipalization of cooperative assets contributes to REC financial difficulties is a matter of some controversy. What is clear, however, are the increasingly-frequent territorial confrontations between federally-financed cooperatives and their municipal counterparts.[132] RECs assert that the practice of annexation and condemnation of cooperative service areas amounts to little more than "cream skimming" by municipalities; areas developed through REC initiative and federal financing are expropriated once they have matured, thereby depriving cooperative members of the benefits of their hard work.[133]

Morgan City evidences both RECs' and the REA's (RUS's) fundamental concern that municipalization—through alienation of cooperative assets—threatens the overall integrity of the rural electrification program. Other misgivings exist as well. For example, due to the interdependent nature of the DISCO-G&T relationship, these entities must operate in a coordinated and effective manner.[134] Accordingly, the REA (RUS) requires that such systems submit an "integrated resource plan" (IRP)[135] prior to obtaining new loans.[136] In addition, the Administration (Service)

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131. "Cooperatives cannot expect to solve whatever economic problems—real or imagined—they may have by freezing the existing service territories of municipal utilities and preventing municipal utilities from growing as the community grows." *Rural Consumer Protection Act of 1994: Hearings on H.R. 3790 Before the Subcomm. on Env't, Credit, and Rural Dev. of the House Comm. on Agric.*, 103d Cong., 2d Sess. 167 (1994) [hereinafter *Rural Consumer Protection Act Hearings*] (statement of Larry Watson, Manager of Paragould, Arkansas, City Light, Water and Cable, on behalf of the APPA). *But see* James A. Orr & Barrett K. Hawks, *Case Studies in Electric Utility Competition Litigation*, NAT. RESOURCES & ENV'T, Winter 1994, at 29 (labeling municipalization of cooperative service territories one of the "gravest threats" faced by RECs).

132. " 'The gradual growth of rural electric utilities and the need for municipalities to expand outward has set two natural allies on a collision course. . . . Confrontations are now occurring in nearly every state, and rural electric systems appear to be losing more than they are winning.' " *National Plan Sought to Address Muni Annexations of Cooperatives*, ELEC. UTIL. WK., Feb. 20, 1989, at 1 (quoting National Rural Utilities Cooperative Finance Corporation (CFC) governor Charles Gill). *See also NRECA Survey Shows 13 States See Territorial Disputes as Serious*, ELEC. UTIL. WK., July 31, 1989, at 9 (reporting that a 1989 NRECA survey rated territory loss through municipalization as the "most serious" problem faced by Colorado and Kansas cooperatives and a "very serious" problem confronting cooperatives in Missouri, Illinois, Wisconsin, Louisiana, Arkansas, Nebraska, and Tennessee).

133. *See NRECA Sees Morgan City Case Crucial to Survival of Cooperative Program*, *supra* note 80, at 6.

134. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 81-82 (statement of REA Administrator Wally Beyer).

135. "Integrated resource plan" denotes a set of regulations designed to promote maximum efficiency in the production and use of electricity. Scott F. Bertschi, Comment, *Integrated Resource Planning and Demand-Side Management in Electric Utility Regulation: Public Utility Panacea or a Waste of Energy?*, 43 EMORY L.J. 815 (1994). On the topic of integrated resource planning, see Shimon Awerbuch, *Market-Based IRP: It's Easy!!!*, ELEC. J., Apr. 1995, at 50. *See also* Eric Hirst, *The Future of IRP and Other Public Goods in a Market-Driven World*, ELEC. J., Apr. 1995, at 74.

136. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 82 (statement of REA Administrator Wally Beyer).

promotes "demand-side management" (DSM)[137] techniques on the part of cooperatives in an effort to foster efficient resource allocation, thereby reducing the need for the construction of new and expensive base load generating capacity.[138] Municipalization, by subverting the territorial integrity of cooperative service areas, disrupts IRP and DSM efforts.[139]

Cost recovery for stranded assets is another dilemma confronting an REC whose service territory has undergone condemnation.[140] Stranded assets are most often the result of generating capacity rendered unuseful when a portion of the electric utility's load is removed from the system.[141] This phenomenon frequently translates into great revenue loss.[142] Nevertheless, while cooperatives do receive compensation for expropriated property, the calculus for such varies widely and stranded costs are rarely awarded.[143]

Though RECs affected by municipalization are alloted remuneration for lost territorial service rights, this figure seldom reflects the annexed

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137. "Demand-side management" is defined as an electric utility-financed attempt to control the amount of future peak generating capacity required by increasing the efficiency with which the utility's customers consume power. Nyce, *Demand Side Management and Energy Conservation*, ARMY LAW., Jan. 1992, at 35. For a thorough analysis of demand-side management practices, see Steven Stoft & Richard J. Gilbert, *A Review and Analysis of Electric Utility Conservation Incentives*, 11 YALE J. ON REG. 1 (1994). *See also* Bertschi, *supra* note 135, at 830-32, 839-49; Edward Moscovitch, *DSM in the Broader Economy: The Economic Impacts of Utility Efficiency Programs*, ELEC. J., May 1994, at 14. *But see* Ahmad Faruqui et al., *Clouds in the Future of DSM*, ELEC. J., Aug. 1994, at 54; William LeBlanc, *Energy Service Marketing: ESM Supplants DSM*, PUB. UTILS. FORT., July 1, 1995, at 20.

138. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 82 (statement of REA Administrator Wally Beyer).

139. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 82 (statement of REA Administrator Wally Beyer).

140. *Agriculture Department Backs Territory Bill, but Muni Opposition Staunch*, ELEC. UTIL. WK., May 9, 1994, at 4 (quoting REA Administrator Wally Beyer who stated, "[S]tranded costs are often unrecognized").

141. *See* Robert J. Michaels, *Unused and Useless: The Strange Economics of Stranded Investment*, ELEC. J., Oct. 1994, at 12 (stating "without customers to buy the power, the plants are 'stranded' "). *See also* Eric Hirst & Lester Baxter, *How Stranded Will Electric Utilities Be?*, PUB. UTILS. FORT., Feb. 15, 1995, at 30 (noting "stranded assets [result from the combination of] expensive power plants and excess capacity"); Alfred E. Kahn, *Can Regulation and Competition Coexist? Solutions to the Stranded Cost Problem*, ELEC. J., Oct. 1994, at 23; Bernard S. Black, *A Proposal for Implementing Retail Competition in the Electricity Industry*, ELEC. J., Oct. 1994, at 58. Because stranded costs are generally associated with excess generating capacity, a cooperative's G&T is the focal point for resulting economic losses. *See Rural Consumer Protection Act Hearings*, *supra* note 131, at 82-83 (statement of REA Administrator Wally Beyer).

142. *See Rural Consumer Protection Act Hearings*, *supra* note 131, at 82-83 (statement of REA Administrator Wally Beyer).

143. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 82 (statement of REA Administrator Wally Beyer). *But see Rural Consumer Protection Act Hearings*, *supra* note 131, at 207:

> If there is stranded investment, or if the wholesale supplier [of electricity] is left with unusable facilities due to annexation, it is not because they were not aware of the risks involved, it [is] because they [chose] to ignore the trends and forecasts and instead . . . forge ahead with their individual plans.

(statement of John Allum, Executive Director of the Colorado Association of Municipal Utilities).

area's "growth potential."[144] This neglect is a primary REA (RUS) concern, as it denies cooperatives the economic fruits of projected development.[145] It is not uncommon for such losses to total several million dollars.[146]

2. The City/State Perspective

Predictably, municipalities and their representative organizations view the "problem" of municipalization differently than do RECs and the REA (RUS). These entities dismiss REA (RUS) admonitions that condemnation of cooperative service territories threatens the security of rural electrification loans. Municipalization proponents point to a 1991 Administration study which concluded that of the over $53 billion in REA loans disbursed since 1936, losses ascribed to default totalled a mere $37,000.[147] Public power supporters further assert that REC growth in terms of both customers and kilowatt-hour sales currently exceeds that of municipal systems.[148] They cite National Rural Electric Cooperative Association (NRECA) figures which disclose that RECs acquired approximately 286,000 additional customers in 1992, an increase of two and one-half percent.[149]

While rural electric systems equate municipalization with the predation of lucrative cooperative loads, municipalities note that annexations are not unilateral.[150] Rather, they are typically requested and voted on by citizens desiring the full range of amenities a municipality offers.[151] Moreover,

144. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 83 (statement of REA Administrator Wally Beyer). *But see Rural Consumer Protection Act Hearings*, *supra* note 131, at 350 (statement of the Missouri Basin Municipal Power Agency) (testifying "many state territory laws require compensation that includes a percentage of revenues from the new customers [acquired after annexation]").

145. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 83 (statement of REA Administrator Wally Beyer). *But see Rural Consumer Protection Act Hearings*, *supra* note 131, at 346 (statement of Thaine J. Michie, General Manager of Platte River Power Authority, Fort Collins, Colorado) (testifying that under Colorado law, a cooperative affected by municipalization is to receive for ten years thereafter 25% of revenues from customers existing at the time of and 5% of revenues for new customers added after annexation).

146. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 83 (statement of REA Administrator Wally Beyer) (testifying "[one particular] electric cooperative [near Billings, Montana] has lost the opportunity to serve 2,500 residential and 200 commercial potential customers with annual revenue of $2,550,000 due to annexations by the city").

147. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 161 (statement of Larry Watson, Manager of Paragould, Arkansas, City Light, Water and Cable, on behalf of the APPA).

148. *Cooperatives Renew Effort to Protect Territories from Municipal Takeover*, ELEC. UTIL. WK., Feb. 14, 1994, at 7 (statement of APPA Assistant Executive Director Alan Richardson). *See also Rural Consumer Protection Act Hearings*, *supra* note 131, at 206 (statement of John Allum, Executive Director of the Colorado Association of Municipal Utilities) (testifying "Department of Energy data shows that [c]oops . . . are growing at a faster pace than municipal electric systems").

149. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 159 (statement of Larry Watson, Manager of Paragould, Arkansas, City Light, Water and Cable, on behalf of the APPA) (testifying "[t]he co-op customer base has grown every year since 1935").

150. *See Agriculture Department Backs Territory Bill, but Muni Opposition Staunch*, *supra* note 140, at 3 (quoting Robert Isaac, Mayor of Colorado Springs, Colorado).

151. *See Agriculture Department Backs Territory Bill, but Muni Opposition Staunch*, *supra* note 140, at 3 (quoting Robert Isaac, Mayor of Colorado Springs, Colorado).

municipalities maintain that their ability to provide unified utility services—both inside the city proper and throughout surrounding communities—is indispensible to attracting and retaining residents and commercial and industrial customers.[152] Thus, the power to annex and condemn REC service territories becomes an essential tool for both state and regional economic development.[153]

Public power supporters label as misguided REA (RUS) characterizations of municipalization as unrestrained. These proponents point out that most states have enacted laws designed to apportion service areas among their electric utilities.[154] Although the territorial protections such schemes afford RECs vary by state,[155] municipalities contend that cooperatives are nevertheless thereby adequately safeguarded from condemnation power abuses.[156]

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152. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 352 (statement of the Missouri Basin Municipal Power Agency). *See also Rural Consumer Protection Act Hearings*, *supra* note 131, at 207:

> Growth around municipalities does not occur because the [c]oop is there to provide electric service; growth occurs because the municipality is there to provide a full range of essential government services, including fire, police, water, and sewer services. If there is a problem, it is not municipal annexation, but extending federal loans to [c]oops to serve in increasingly suburban and urban, not rural, areas.

(statement of John Allum, Executive Director of the Colorado Association of Municipal Utilities).

153. *Rural Consumer Protection Act Hearings*, *supra* note 131, at 352 (statement of the Missouri Basin Municipal Power Agency).

154. *See NRECA Survey Shows 13 States See Territorial Disputes as Serious*, *supra* note 132, at 10 (quoting APPA Executive Director Larry Hobart). *But see Minnesota Passes Law Banning Munis from Using 'Quick-Take' Eminent Domain*, ELEC. UTIL. WK., May 16, 1994, at 3. The following states have enacted electric utility "territorial allocation" laws: Alabama- ALA. CODE § 37-14-1 (1975); Alaska- ALASKA STAT. § 42.05.221(d) (1989); Arizona- ARIZ. REV. STAT. ANN. § 40-281 (1985); Arkansas- ARK. CODE ANN. § 23-18-101 (Michie 1987); California- CAL. PUB. UTIL. CODE § 1001 (Deering 1990); Colorado- COLO. REV. STAT. § 40-5-101 (1993); Connecticut- CONN. GEN. STAT. § 16-245 (1992); Delaware- DEL. CODE ANN. tit. 26, § 203A (1989); Florida- FLA. STAT. ANN. § 366.04 (West 1968 & Supp. 1995); Georgia- GA. CODE ANN. § 46-3-2 (1973); Idaho- IDAHO CODE § 61-332 (1970); Indiana- IND. CODE § 8-1-2-86 (1993); Iowa- IOWA CODE § 476.24 (1976); Kansas- KAN. STAT. ANN. § 66-1, 172 (1976); Kentucky- KY. REV. STAT. ANN. § 96.538 (1982); Louisiana- LA. REV. STAT. ANN. § 45:123 (West 1970); Maine- ME. REV. STAT. ANN. tit. 35-A, § 2103 (West 1991); Maryland- MD. CODE ANN. art. 78, § 53 (1992); Massachusetts- MASS. GEN. LAWS ANN. ch. 164, § 87 (West 1993); Michigan- MICH. COMP. LAWS ANN. §§ 460.502, 483.102 (West 1991 & Supp. 1993); Minnesota- MINN. STAT. § 216B.39 (1974); Mississippi- MISS. CODE ANN. § 77-3-11 (1968); Missouri- MO. REV. STAT. § 393.106(2) (1986); Montana- MONT. CODE ANN. § 69-5-105 (1971); Nebraska- NEB. REV. STAT. § 70-1002(3) (1981); New Jersey- N.J. STAT. ANN. § 48.7-17 (West 1983); New Mexico- N.M. STAT. ANN. § 3-24-1 (Michie 1995); North Carolina- N.C. GEN. STAT. § 62-110.2 (1971); North Dakota- N.D. CENT. CODE § 49-03-01 (1965); Ohio- OHIO REV. CODE ANN. § 4933.82(B) (Anderson 1978); Oklahoma- OKLA. STAT. tit. 17, § 158.23 (1988); Oregon- OR. REV. STAT. § 758.400-.475 (1985); Pennsylvania- 15 PA. CONS. STAT. § 3279 (1975); Rhode Island- R.I. GEN. LAWS § 39-3-1 (1957); South Carolina- S.C. CODE ANN. § 58-27-640 (Law. Co-op. 1984); Tennessee- TENN. CODE ANN. § 6-51-111 (1968); Texas- TEX. UTIL. CODE ANN. §§ 50-51 (West 1975); Utah- UTAH CODE ANN. § 54-4-25 (1981); Vermont- VT. STAT. ANN. tit. 30, § 249 (1969); Virginia- VA. CODE ANN. § 56-265.3 (Michie 1988); Wisconsin- WIS. STAT. ANN. § 196.495 (West 1983); Wyoming- WYO. STAT. § 37-2-205 (1977).

155. *See supra* note 154.

156. *See Rural Consumer Protection Act Hearings*, *supra* note 131, at 274 (statement of the Edison Electric Institute).

As even the casual observer of the electric utility industry is aware, a transition to competitive markets in electricity generation is currently underway.[157] Municipalization proponents have seized upon this doctrinal revolution and are quick to assert that expropriation of REC service territories is often consistent with the recently-enacted Energy Policy Act's (EPAct)[158] goal of encouraging competition in the wholesale electricity market.[159] These interests also note that section 212(g) of the Federal Power Act (FPA),[160] as amended by the EPAct, expressly precludes federal interference with state-established retail service territories.[161]

V. CONCLUSION

The divergent views regarding municipalization are unlikely to be reconciled in the immediate future.[162] Given the increasing competitiveness of

157. *See, e.g.*, Richard J. Pierce, Jr., *The State of the Transition to Competitive Markets in Natural Gas and Electricity*, 15 ENERGY L.J. 323, 328-49 (1994) Notice of proposed Rulemaking and Supplemental Notice of Proposed Rulemaking, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, IV F.E.R.C. STATS. & REGS. ¶ 32,514 (1995) (commonly referred to as the "Mega-NOPR"). *See also* Douglas Gagax & Kenneth Nowotny, *Competition and the Electric Utility Industry: An Evaluation*, 10 YALE J. ON REG. 63 (1993); Linda S. Portasik, *The Transition to Fully Competitive Bulk Power Markets: Federal Regulatory Developments in the Electric Power Industry*, 15 ENERGY L.J. 365 (1994); Vinod K. Dar, *The Future of the U.S. Electric Utility Industry*, ELEC. J., July 1995, at 16, 17; Vikram S. Budhraja, *Generation as a Business—Facts, Fumbles, Fictions and the Future*, ELEC. J., July 1995, at 36; *The Battle Over Retail Competition: A Dialogue*, ELEC. J., June 1994, at 64; Black, *supra* note 141, at 58; Richard J. Pierce, Jr., *The Advantages of De-Integrating the Electricity Industry*, ELEC. J., Nov. 1994, at 16; Roger W. Sant & Roger F. Naill, *Let's Make Electricity Generation Competitive*, ELEC. J., Oct. 1994, at 49; William R. Hughes & George R. Hall, *Substituting Competition for Regulation*, 11 ENERGY L.J. 243 (1990) (discussing the practical effects of displacing regulation with competition).

158. Pub. L. No. 102-486, 106 Stat. 2776 (1992).

159. *See Rural Consumer Protection Act Hearings*, *supra* note 131, at 352 (statement of the Missouri Basin Municipal Power Agency) (referring to title 7 of the EPAct and stating "dissatisfied . . . co-op customers can vote to privatize their utility. This franchise competition encourages [co-op] managers to operate efficiently and provide quality service."). *See also Rural Consumer Protection Act Hearings*, *supra* note 131, at 275 (statement of the Edison Electric Institute).

160. 16 U.S.C. § 212(g) (1994).

161. *See Rural Consumer Protection Act Hearings*, *supra* note 131, at 352 (statement of the Missouri Basin Municipal Power Agency).

162. One recent study of the municipal takeover of privately-owned electrical generating facilities maintains:

> [T]here are both theoretical and practical arguments in favor of public enterprise. Indeed, public ownership may be more efficient at supplying certain services that would be undersupplied under private ownership. However, *a priori* and empirically there is little to support this view in the case of electricity.
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> . . . .
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> . . . In the case specifically of electric utilities, while there are some studies that provide evidence of superior efficiency for publicly[-]owned utilities, there are serious problems with these studies. The survey of the evidence clearly does not provide a very strong basis for proposing municipal takeover. From the evidence surveyed there is little support on efficiency grounds for municipal takeover.

MICHAEL A. CREW & PAUL R. KLEINDORFER, THE REASON FOUND., PUBLIC VERSUS PRIVATE: ALTERNATIVE OWNERSHIP SCENARIOS FOR ELECTRIC UTILITIES 3, 13 (1990).

electricity generation, it is arguable that any solution should be a uniform (i.e. federal) one, to ensure a level playing field for all those seeking to compete in developing regional and national power markets.[163] Regardless of one's views as to the utility or propriety of regulation in general, or the necessity for resolution of the municipalization conundrum in particular, it is inescapable that a legislative solution is preferable to a judicial one.

The Fifth Circuit Court of Appeals' *Morgan City* ruling amounts to an attempt at policymaking by the federal judiciary. Such policy, if it is to be formulated at all, properly lies within the province of elected officials. *Morgan City* constitutes a "breathtaking federal power grab"[164] which diminishes states' rights and defies congressional intent. Absent authority to annex and condemn outlying areas—and to extend municipal services to these areas (including those provided electrical service by RECs)—both cities and states are limited in their ability to promote growth and economic development. Nothing in the REAct suggests cooperatives are to receive shelter from the rigors of the marketplace at such a price.

Joel A. Youngblood

163. The magnitude of this ideological rift, as indicated by both the capital investment and revenue at stake in resulting territorial struggles, has prompted at least one recent federal attempt at a legislative solution. Specifically, on February 7, 1994, Rep. Jill Long (D-IN) introduced into Congress H.R. 3790. Entitled the "Rural Consumer Protection Act," the bill seeks to establish a federal scheme of regulation for municipal acquisition of cooperative service territories.

On May 4, 1994, hearings on H.R. 3790 were conducted. *See Rural Consumer Protection Act Hearings*, *supra* note 131. While hearings on the bill have long-since concluded, no legislative action has yet been taken. Bill Tracking Report (Federal)- H.R. 3790, July 23, 1995, *available in* LEXIS, CODES Library, BLTRCK File.

164. *Morgan City*, 49 F.3d at 1076 (Jones, J., dissenting).