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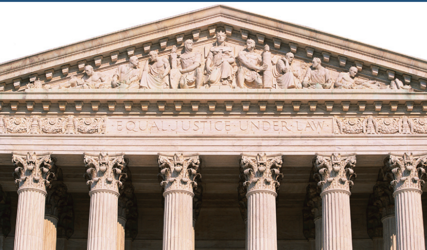

REPORT FROM WASHINGTON

Supreme Court Considers FERC's Ability To Void Wholesale Energy Contracts

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TO VIEW A TRANSCRIPT OF THE ORAL ARGUMENTS BEFORE THE SUPREME COURT OF THE UNITED STATES IN THE *MORGAN STANLEY CAPITAL GROUP* CASE, PLEASE CLICK HERE.

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On February 19, the Supreme Court heard oral arguments in the consolidated cases *Morgan Stanley Capital Group v. Public Utility Dist. 1, et al.*, Docket No. 06-1457 (U.S.), and *American Elec. Power Serv. Corp., et al. v. Public Utility Dist. 1, et al.*, Docket No. 06-1462 (U.S.), regarding the ability of the Federal Energy Regulatory Commission ("FERC") to abrogate otherwise valid wholesale energy contracts. Specifically, the Court is considering whether the Ninth Circuit erred in its interpretation of *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956) ("*Mobile*"), and *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) ("*Sierra*"). Historically, FERC interpreted the *Mobile-Sierra* cases and their progeny as effectively precluding FERC's ability to retroactively void valid, bilaterally negotiated wholesale energy contracts absent a showing that such a change would further the "public interest." In the wake of the Energy Crisis of 2000-2001, FERC refused to void certain challenged agreements—based on the *Mobile-Sierra* doctrine—despite the well publicized "market disruptions" in energy markets during that period in California, Nevada, and Washington caused by a convergence of various factors, including (according to a FERC report) market manipulations by some sellers, scarcity of supply, increased demand due to abnormally hot weather, unplanned outages of electric generation and gas pipeline facilities, and flawed market rules.

The central issues before the Court are whether FERC must apply the "public interest" standard in these cases, and whether the market disruptions caused by the Energy Crisis are grounds for abrogating the challenged agreements, regardless of whether the "public interest" standard applies. The Court's decision will determine FERC's ability to void negotiated contracts entered into pursuant to FERC-authorized "market based" tariffs in circumstances in which one party argues

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JUSTICE SCALIA

that disruptions in power markets cause the negotiated prices to be unjust and unreasonable. If the Court supports this challenge to previously negotiated power contracts based on market factors, it could have a chilling effect on power markets, which rely upon the sanctity of such agreed terms.

BACKGROUND

The disputes at issue in the *Morgan Stanley* and *American Electric Power* appeals arise out of the Energy Crisis of 2000-2001, during which a group of power purchasers in California, Nevada, and Washington entered into wholesale energy contracts for future energy supplies during a period of price volatility. After energy prices declined, those power purchasers filed complaints with FERC to modify those contracts, claiming that the agreed rates were not just and reasonable. The Federal Power Act ("FPA"), 16 U.S.C. §791a *et seq*., provides FERC with exclusive jurisdiction to review rates charged in the wholesale energy market in interstate commerce and allows FERC to modify a rate that FERC determines, after a hearing, to be "unjust, unreasonable, unduly discriminatory, or preferential."

Two Supreme Court cases, *Mobile* and *Sierra*, have supplied the framework by which FERC has historically reviewed requests to alter wholesale energy contracts. In *Mobile*, the Court held that natural gas companies do not have the unilateral right to change their contract rates merely by filing a new rate with FERC, although FERC may modify the contracts "when necessary in the public interest." In *Sierra*, the Court held that a contract is not unjust or unreasonable simply because it is unprofitable for the seller. The Court added that FERC may void a contract if the rate is "so low as to adversely affect the public interest, such as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." As a result of the *Mobile-Sierra* decisions, and subsequent FERC orders, power marketers inserted language into their contracts affirming that no party could unilaterally change the underlying rates and that any unilateral petition to FERC requesting a rate modification would be held to the strict "public interest" standard. Based on the overwhelming adoption of these so-called "*Mobile-Sierra* clauses" in power contracts, parties assumed that the sanctity of their contracts would be upheld absent extreme circumstances where the "public interest" demanded revision, such as where a contracting party was involved in market manipulation. The "public interest" standard has rarely been met, and has led the D.C. Circuit court to call it "practically insurmountable."

In the current cases, the utilities claim that FERC should apply a more lenient standard of whether the rates were "just and reasonable" in light of the market dysfunctions (as distinct from market volatilities) existing at the time of contract formation. The energy sellers conversely contend that market dysfunction is not a sufficient reason to abrogate contracts and that the *Mobile-Sierra* doctrine requires the utilities to demonstrate that the "public interest" would be served by a modification.

On appeal, the Ninth Circuit held that FERC erred in its procedural reliance on *Mobile-Sierra* and in the substantive standard it used to determine that the disputed contracts did not affect the public interest. The court interpreted *Mobile-Sierra*

to stand "for the proposition that *in certain circumstances*, a presumption applies that private parties to a wholesale electric power contract have negotiated a 'just and reasonable' contract." The court further established three prerequisites for the presumption to apply: "(1) the contract by its own terms must not preclude the limited *Mobile-Sierra* review; (2) the regulatory scheme in which the contracts are formed must provide FERC with an opportunity for effective, timely review of the contracted rates; and (3) where, as here, FERC is relying on a market-based rate-setting system to produce just and reasonable rates, this review must permit consideration of all factors relevant to the propriety of the contract's formation." If the prerequisites are not met, the court held that FERC cannot require petitioners to make a public interest showing, but instead must "find another method of evaluating whether the challenged rates are just and reasonable."

Applying the prerequisites to the cases at bar, the Court of Appeals found that the *Mobile-Sierra* standard was inapplicable. The court determined that FERC did not have an opportunity for effective, timely review of the contracted rates, an error that was "compounded by FERC's substantive adherence to *Mobile-Sierra* without regard" to the frenzied market conditions in which the contracts were formed. Even if *Mobile-Sierra* applied, the court stated that FERC used an erroneous standard for determining the effect on the public interest. The proper standard for the public interest review in a high-rate challenge is whether the contract is "outside the 'zone of reasonableness' and results in retail rates higher than would be the case if that zone were not exceeded."

The Court of Appeals remanded the case to FERC so that FERC could "apply the proper statutory review standards to determine" (1) whether *Mobile-Sierra* review of the challenged contracts was appropriate; (2) if so, to apply the modified form of *Mobile-Sierra* review as outlined in the court's opinion; and (3) if not, to apply full just and reasonable review to the challenged contracts.

The Supreme Court granted certiorari on September 25, 2007, and consolidated the two petitions.

SUMMARY OF THE ARGUMENT

At oral arguments, the Justices focused extensively upon the dueling tensions underlying this dispute: respect for the sanctity of contracts versus the need to protect consumers from unjust and unreasonable rates. On one side, Justice Scalia praised the business acumen of Morgan Stanley and questioned why it should be punished for the market disruptions when there was no evidence that Morgan Stanley had engaged in market manipulation or fraudulent behavior. "Well, good for [Morgan Stanley for buying low and selling high]. I mean, you're suggesting they should be punished for that?" Although indicative of his humor during oral arguments, Justice Scalia's statement appears to support his preference to protect privately negotiated agreements from review by FERC. As he later articulated, a market "dysfunction" always means that the parties "can't predict for sure what the rates are going to be down the road," and thus power purchasers would ***always*** have an argument in favor of the abrogation of a privately negotiated agreement. Justice

"FERC said that it would monitor long-term contracts vigorously for rate reasonableness and that power purchasers could challenge rates through [FPA Section] 206 proceedings. What happened to that position?"

JUSTICE GINSBURG

Scalia appeared wary of any argument that would have this potential impact.

On the other side, Justice Ginsburg seemed to lean toward agreeing with the Ninth Circuit in holding that FERC does have the authority to abrogate these otherwise binding agreements between the parties. Justice Ginsburg's questioning, for example, suggested that FERC's failure to "vigorously" review the underlying market conditions under which sales were made may be reason to err on the side of the power purchasers, rather than the sellers: "FERC said that it would monitor long-term contracts vigorously for rate reasonableness and that power purchasers could challenge rates through [FPA Section] 206 proceedings. What happened to that position?"

Striking a balance between Justices Ginsburg and Scalia, Justice Souter attempted to prod counsel for the power purchasers into giving sufficient reason for the Court to agree with the Ninth Circuit in a way that would avoid Justice Scalia's concern that ***all*** agreements would be subject to abrogation. Indeed, the power purchasers' argument was not a "modest" one and Justice Souter requested that counsel provide "limiting principles" that would guarantee the enforceability of agreements absent some extraordinary circumstances. Unsatisfied with counsel's responses, Justice Souter engaged in a lengthy "cross-examination," apparently searching for a middle ground.

One possible middle ground that Justice Souter seemed to suggest is the prospect that market dysfunctions caused principally by market manipulation might be reversible, although it was not clear what result third party manipulation should have on other market participants. Several of the Justices queried whether there was a difference between market dysfunctions caused by the weather and market dysfunctions caused by the indirect market manipulation of other sellers—at least from an equity perspective, as Justice Scalia pointed out, there is little difference to power purchases between market dysfunctions caused by the weather and market dysfunctions caused by the market manipulations of some other third parties. Thus, while it appears that high prices, "buyer's remorse" and unspecified causes of "market dysfunction" alone are not sufficient to abrogate negotiated power contracts, it is uncertain where the Court will draw the line on the issue. Nevertheless, the guideposts given by the Justices at oral arguments suggest that the Court—if at all—would allow the abrogation of an agreement only where the market dysfunction was the result of some form of market manipulation (as opposed to market forces), and it is possible that the Court would require some nexus between the market manipulation and the subject of the agreement.

IMPLICATIONS

There is an obvious tension between the desire to protect privately negotiated contracts with the need to recognize the role FERC plays in overseeing and correcting market dysfunctions in the energy markets. If the Supreme Court were to affirm the Ninth Circuit Court of Appeal's decision, bilateral agreements would be subject to increased uncertainty. The Court would further open the door for those wishing to challenge energy prices previously agreed upon on the basis that such prices are not "just and reasonable" in the face of changing market dynamics. A reversal, on the other hand, would provide increased contractual protection to the

agreements between public utilities and their customers. However, any victory for the power purchasers in this instance would likely be tempered by the fact that FERC would still be asked to resolve the central issues (e.g., were rates just and reasonable and did FERC adequately monitor markets) in further proceedings, consistent with the legal principles established in this case. FERC's previous rulings on this point—many of which underline the burden FERC has consistently imposed on parties asking to modify negotiated rates—suggest that a victory for the power purchasers before the Court may simply lead to another round of uphill battles at FERC and federal appeals courts.

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