

A Deal Is Still a Deal: *Morgan Stanley Capital Group v. Public Utility District No. 1*

*Richard P. Bress, Michael J. Gergen, and Stephanie S. Lim**

A deal is a deal. This concept is firmly entrenched in American culture and law,¹ and is widely viewed as an essential cornerstone of economic development and stability.² It has thus long been understood in our nation that it is not the role of the government to relieve contracting parties of “hard bargains” resulting from their “indiscretions and bad judgments”; rather, the Constitution “with

* Richard P. Bress and Michael J. Gergen are partners, and Stephanie S. Lim is an associate, at Latham & Watkins LLP. The authors represented various sellers in the proceedings addressed in this article. The authors would like to thank Barry J. Blonien, also an associate at Latham & Watkins LLP, and David G. Tewksbury, a partner at Kirkland & Ellis LLP, for their assistance in preparing this article.

¹ See, e.g., Charles Fried, *Contract as Promise: A Theory of Contractual Obligation* (Harvard University Press 1981) (characterizing American contract law as being rooted in a moral obligation to enforce a promise).

² Economists have long recognized the critical importance of contracts as a source of economic growth. See, e.g., Adam Smith, *The Wealth of Nations* bk. I, ch. IX, at 133 (Edwin Cannan ed., Bantam Dell 2003) (1776) (“When the law does not enforce the performance of contracts, it puts all borrowers nearly upon the same footing with bankrupts.”); Ross Levine, *The Legal Environment, Banks and Long-Run Economic Growth*, 30 *J. Money, Credit and Banking* 596 (1998) (contract enforceability facilitates the development of efficient banking systems and financial markets, which, in turn, support economic growth); Daniel Kaufman, et al., *Governance Matters*, World Bank Policy Research Working Paper No. 2196 (1999) (contract enforceability a key component of the “rule of law,” which is critical to economic development). More recently, economists have stressed the importance of contract enforcement in promoting development, especially with respect to economic regulation of capital-intensive industries, such as the electric and natural gas industries. See, e.g., Mark A. Jamison, et al., *Measuring and Mitigating Regulatory Risk in Private Infrastructure Investment*, 18 *Electricity J.* 36 (July 2005); Mario Bergara, et al., *Political Institutions and Electric Utility Performance: A Cross Nation Analysis*, 40 *Cal. Mgmt. Rev.* 18 (1998); Pablo Spiller, *A Positive Political Theory of Regulatory Instruments: Contracts, Administrative Law or Regulatory Specificity*, 69 *S. Cal. L. Rev.* 477 (1996).

its conservative energy . . . requires contracts, not illegal in their character, to be enforced as made by the parties, even against any State interference with their terms.”³

This historical respect for the integrity of contracts was tested and strongly reaffirmed this term in *Morgan Stanley Capital Group Inc. v. Public Utility District No. 1 of Snohomish County*.⁴ *Morgan Stanley* presented the Supreme Court with the question whether the Federal Energy Regulatory Commission (FERC or the Commission)⁵ could or should exercise its authority under the Federal Power Act (FPA) to abrogate or modify contracts for the purchase and sale of large amounts of electricity entered into in the western energy crisis of 2000–2001.⁶

During the western energy crisis, many large sophisticated parties faced with volatile spot markets signed long-term contracts to meet their electricity needs. While the contract rates were undeniably high relative to historic forward market prices, they were generally lower than contemporaneous spot prices and insulated the buyers from any further price increases in the spot and forward markets. The buyers initially expressed satisfaction with the deals they struck, and some resold portions of their allotments for huge profits in the spot markets. But the buyers’ satisfaction was short-lived. By the summer of 2001, prices in the spot markets had declined significantly, and the contract rates no longer appeared favorable. The buyers cried foul and filed complaints asking FERC to relieve them

³ *Wilmington & W.R. Co. v. King*, 91 U.S. 3, 5 (1875) (also recognizing that governmental intrusion into contractual relations simply to relieve parties of their “hard bargains” would “create an insecurity in business transactions which would be intolerable”).

⁴ 555 U.S. —, 128 S. Ct. 2733 (2008).

⁵ Throughout this article, we also use the terms “FERC” or the “Commission” to refer to the Federal Power Commission, FERC’s predecessor.

⁶ The scheme of regulation under the FPA, which applies to the interstate transmission and sale at wholesale of electricity, is “substantially identical” to that under the Natural Gas Act (NGA), which applies to the interstate transport and wholesale sale of natural gas, and decisions addressing the FPA and NGA are therefore cited “interchangeably.” *Ark. La. Gas Co. v. Hall*, 453 U.S. 571, 578 n.7 (1981) (citation omitted). Accordingly, while *Morgan Stanley*, and thus this article, is specifically focused on the regulation of electricity contracts under the FPA, the case’s holdings and implications are equally applicable to the regulation of natural gas contracts under the NGA.

of their contractual obligations, now claiming that the prices they had lauded were “unjust and unreasonable.” FERC rejected these complaints, finding that contract modification was not required simply because the contracts had “become[] uneconomic over time.”⁷

The buyers found a more sympathetic ear in the Ninth Circuit. In a decision that trampled the law’s traditional deference to contracts, the court of appeals reversed the Commission’s ruling. In the Ninth Circuit’s view, an electricity or natural gas contract cannot be enforced as written unless FERC first has the opportunity to decide whether the contract is “just and reasonable” and ensures that no exogenous factors affected the “propriety of the contract’s formation.”⁸ And even then, if the party challenging the contract is the buyer claiming the price is too high, FERC, as the federal agency charged with protecting consumer welfare, must lower the rate to marginal cost—regardless of the effect of such interference on the long-term supply and cost of power.

The Supreme Court flatly rejected the Ninth Circuit’s decision and its conception of the FPA as an all-encompassing regulatory scheme with pervasive governmental oversight of contractual relations. Drawing on the language of the statute and decades of precedent, the Court reaffirmed that government interference with contracts is permitted only in rare circumstances of overwhelming public necessity. In so holding, the Court recognized the presumptive reasonableness of voluntary agreements and the long-term harm to consumers that would result from casual governmental interference with contractual bargains. By firmly reinforcing the limits of permissible government interference with private energy contracts, even in the face of a historic energy crisis that produced unprecedented high prices and volatility, the Court’s decision in *Morgan Stanley* makes it clear that, at least with respect to FERC-regulated electricity and natural gas contracts, a deal is still a deal.

I. Regulatory Background

Congress enacted Part II of the FPA in 1935 to regulate the interstate transmission and sale at wholesale of electricity “in the public

⁷ *Nev. Power Co. v. Enron Power Mktg., Inc.*, 103 F.E.R.C. ¶ 61,353, at 62,384 (2003) (“Nevada Power Initial Order”), reh’g denied, 105 F.E.R.C. ¶ 61,185 (2003) (“Nevada Power Rehearing Order”).

⁸ *Pub. Util. Dist. No. 1 of Snohomish County, Washington v. FERC*, 471 F.3d 1053, 1077 (9th Cir. 2006) (“Snohomish”).

interest”⁹ because it was concerned that the market was dominated by vertically integrated utilities with the ability to use their monopoly power to raise prices.¹⁰ At the same time, Congress recognized that electricity sales might not be well-suited for the traditional model of regulation in which utilities are required to file generally applicable rate tariffs. As with natural gas, the sale or transmission of electricity “typically require[s] substantial investment in capacity and facilities for the service of a particular distributor,” and therefore required “individualized arrangements” that would not conform to broadly applicable tariff schedules.¹¹ Further, “[i]n wholesale markets, the part[ies] . . . were often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a ‘just and reasonable’ rate as between the two of them.”¹²

Under the FPA’s regulatory scheme, FERC is directed to ensure that all rates for electricity are “just and reasonable.”¹³ But this does not mean that the Commission must take an active role in setting rates. The FPA “departed from the scheme of purely tariff-based regulation” and “acknowledged that contracts between commercial buyers and sellers could be used in ratesetting.”¹⁴ Whether contractual or tariff-based, the rates filed with the Commission automatically become effective “[u]nless the Commission otherwise orders.”¹⁵ At the same time, the Commission is required to correct any rate that it finds to be “unjust, unreasonable, unduly discriminatory or preferential.”¹⁶

II. The *Mobile-Sierra* Doctrine

By allowing parties to enter into and set rates through contract and yet also requiring the Commission to ensure that all rates are just

⁹ 16 U.S.C. § 824(a).

¹⁰ See *FPC v. Texaco Inc.*, 417 U.S. 380, 397–98 (1974).

¹¹ *United Gas Pipe Line Co. v. Mobile Gas Servs. Corp.*, 350 U.S. 332, 339 (1956).

¹² *Verizon Commc’ns, Inc. v. FCC*, 535 U.S. 467, 479 (2002).

¹³ 16 U.S.C. § 824d(a).

¹⁴ *Verizon*, 535 U.S. at 479; see also 16 U.S.C. § 824d(c) (requiring contracts to be filed with the Commission).

¹⁵ 16 U.S.C. § 824d(d).

¹⁶ 16 U.S.C. § 824e(a). The Commission’s authority to modify rates, however, is not limitless—rather, rate changes ordered by the Commission have only prospective effect. See *id.*; see also 16 U.S.C. § 824e(b) (the Commission may only order refunds for sales occurring after a “refund effective date” that is established, at the earliest, upon the filing of a complaint).

and reasonable, Congress enacted a regulatory scheme that requires balance between the freedom and obligations of contract and governmental ratemaking responsibility. The Court first addressed this balance in two companion cases decided in 1956.

In the first case, *United Gas Pipe Line Co. v. Mobile Gas Services Corp.*,¹⁷ United Gas Pipe Line Company agreed to sell natural gas under a long-term contract at a rate substantially lower than its normal price. The buyer, in turn, entered into a separate contract to resell the gas at a rate just slightly higher than that set in its contract with United. During the term of the contract, however, United asked the Commission to set a new and higher rate that would be consistent with United's other rates. The Commission approved the new rate over the buyer's objections.

The Supreme Court reversed. The Court distinguished common carrier regimes such as "the Interstate Commerce Act, which in effect precludes private rate agreements by its requirement that the rates to all shippers be uniform."¹⁸ The Natural Gas Act, in contrast, "permits the relations between the parties to be established initially by contract,"¹⁹ and "evinces no purpose to abrogate private rate contracts as such."²⁰ Because the NGA "purports neither to grant nor to define the initial rate-setting powers of natural gas companies,"²¹ the Court found "that, except as specifically limited by the Act, the rate-making powers of . . . companies were to be no different from those they would possess in the absence of the Act," including the power "to fix by contract, and change only by mutual agreement, the rate agreed upon with a particular customer."²² Under this scheme, the Commission simply has no authority to permit a party to renege on its contractual bargain. The Court observed that, "[b]y preserving the integrity of contracts, [the Act] permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry."²³ At the same time, "the contracts remain

¹⁷ 350 U.S. 332 (1956) ("Mobile").

¹⁸ *Id.* at 338.

¹⁹ *Id.* at 339.

²⁰ *Id.* at 338.

²¹ *Id.* at 341.

²² *Id.* at 343.

²³ *Id.* at 344.

fully subject to the paramount power of the Commission to modify them when necessary in the public interest."²⁴ By retaining this governmental oversight, the statute "affords a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other."²⁵

The very same day, the Court issued *FPC v. Sierra Pacific Power Co.*,²⁶ which addressed similar issues in the context of the FPA. In *Sierra*, a seller, Pacific Gas and Electric Company (PG&E), had voluntarily agreed to make long-term sales at a "special low rate"²⁷ to dissuade one of its customers from seeking out alternative supply sources. As in *Mobile*, the seller later asked the Commission to raise the contract rate to bring it in line with the seller's other rates. However, there was one notable difference: Before accepting the new rate, the Commission found the existing contract rate to be "'unreasonably low and therefore unlawful."²⁸ Nonetheless, applying the reasoning of *Mobile*, the Supreme Court reversed. The Court held that proof of an "unreasonably low" rate does not, by itself, permit the agency to modify a contract. It explained that,

while it may be that the Commission may not normally impose upon a public utility a rate which would produce less than a fair return, it does not follow that the public utility may not itself agree by contract to a rate affording less than a fair return or that, if it does so, it is entitled to be relieved of its improvident bargain.²⁹

"In such circumstances," the Court held, "the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest—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."³⁰

²⁴ *Id.*

²⁵ *Id.*

²⁶ 350 U.S. 348 (1956).

²⁷ *Id.* at 352.

²⁸ *Id.* at 354.

²⁹ *Id.* at 355.

³⁰ *Id.*

Together, these two decisions gave rise to what has become known as the “*Mobile-Sierra* doctrine,” under which the Commission may modify contracts “only in circumstances of unequivocal public necessity.”³¹ Based on the Court’s references to the “public interest” in *Mobile* and *Sierra*, the courts and the Commission began to refer to this strict standard (somewhat confusingly, as we discuss later) as the “public interest standard.” Proposed contract modifications will be reviewed under the public interest standard unless the contract contains explicit language indicating that the parties intended otherwise.³² Where a contract does explicitly disclaim application of the public interest standard, the Commission will review proposed changes under the same standard it uses for non-contract rates, which is commonly referred to as the “just and reasonable standard.”³³ While the Commission has considerable discretion in determining the boundaries of the two standards, the courts have made it clear that the public interest standard is far more deferential to parties’ contractual bargains.³⁴ In fact, one court of appeals has gone so far as to characterize the burden imposed by the public interest standard as “practically insurmountable.”³⁵

³¹ In re Permian Basin Area Rate Cases, 390 U.S. 747, 822 (1968); see also Ark. La. Gas Co. v. Hall, 453 U.S. 571, 582 (1981) (contract modification permitted only in “extraordinary circumstances”).

³² See United Gas Pipe Line Co. v. Memphis Light, Gas & Water Div., 358 U.S. 103, 110–13 (1958) (“*Memphis*”) (finding *Mobile* and *Sierra* not to be applicable in the case of a contract that explicitly contemplated the contract price to be subject to modification by the seller); Morgan Stanley Cap. Group Inc. v. Pub. Util. Dist. No. 1 of Snohomish County, 128 S. Ct. 2733, 2739 (2008). Since the Supreme Court’s decision in *Memphis*, the courts have generally held that the *Mobile-Sierra* doctrine applies unless the contract explicitly provides otherwise in a “*Memphis* clause.” See, e.g., Texaco Inc. v. FERC, 148 F.3d 1091, 1096 (D.C. Cir. 1998); Boston Edison Co. v. FERC, 233 F.3d 60, 67 (1st Cir. 2000); La. Power & Light Co. v. FERC, 587 F.2d 671, 675 (5th Cir. 1979).

³³ See Morgan Stanley, 128 S. Ct. at 2740.

³⁴ See, e.g., Atlantic City Elec. Co. v. FERC, 295 F.3d 1, 14 (D.C. Cir. 2002) (public interest standard “is much more restrictive than the just and reasonable standard”); Ne. Utils. Serv. Co. v. FERC, 55 F.3d 686, 691 (1st Cir. 1995) (“[T]he ‘public interest’ standard [is] ‘a more difficult standard for the Commission to meet than the statutory ‘unjust and unreasonable’ standard.’” (citation omitted)).

³⁵ Potomac Elec. Power Co. v. FERC, 210 F.3d 403, 407 (D.C. Cir. 2000); see also Papago Tribal Util. Auth. v. FERC, 723 F.2d 950, 954 (D.C. Cir. 1983). Despite this hyperbole, the courts have in several instances affirmed FERC’s authority to modify electricity and natural gas agreements when it has found that necessary in the public interest. See, e.g., Ariz. Corp. Comm’n v. FERC, 397 F.3d 952, 953–95 (D.C. Cir. 2005)

Mobile and *Sierra* have been described as two of the “best-known public utility decisions by the Supreme Court in [the 20th] century,”³⁶ and buyers and sellers of electricity and natural gas have understood for decades that they bargain “in the shadow of the [*Mobile-Sierra*] doctrine.”³⁷ Although the Commission has often chafed at the limitations on its authority imposed by *Mobile-Sierra*,³⁸ the courts have repeatedly reaffirmed the protection the doctrine affords freedom of contract.³⁹

III. FERC Applies *Mobile-Sierra* to Reject Buyers’ Challenges to the Long-Term Contracts They Signed During the Western Energy Crisis

The western energy crisis has been characterized as “the worst electricity-market crisis in American history.”⁴⁰ From the summer of 2000 through the spring of 2001, prices in the California spot electricity markets “jumped dramatically—more than fifteenfold,” and those high prices “spilled over into other Western States.”⁴¹ The causes of those high prices have been the subject of much litigation, which we do not address in detail here, except to note that FERC has attributed the price increases to a “confluence of factors,” including:

flawed market rules; inadequate addition of generating facilities in the preceding years; a drop in available hydropower due to drought conditions; a rupture of a major pipeline supplying natural gas into California; strong growth in the economy and in electricity demand; unusually high temperatures; an increase in unplanned outages of extremely old generating facilities; and market manipulation. This was not

(affirming modification of contracts that would have jeopardized the service provided to third parties); *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 709–12 (D.C. Cir. 2000) (modification of contracts justified in light of industry restructuring), *aff’d sub nom. New York v. FERC*, 535 U.S. 1 (2002).

³⁶ *Boston Edison Co.*, 233 F.3d at 66.

³⁷ *Id.*

³⁸ See *id.* at 69 (noting FERC’s hostility to the *Mobile-Sierra* doctrine).

³⁹ See, e.g., *Potomac Elec. Power Co.*, 210 F.3d at 409; *Texaco, Inc. v. FERC*, 148 F.3d 1091, 1096–97 (D.C. Cir. 1998); *Ne. Utils. Serv. Co. v. FERC*, 993 F.2d 937, 960 (1st Cir. 1993).

⁴⁰ Brief for the Federal Energy Regulatory Commission in Opposition at 12, *Sempra Generation v. Pub. Util. Comm’n of Cal.*, Nos. 06-1454, et al. (U.S. Aug. 2007).

⁴¹ *Morgan Stanley*, 128 S. Ct. at 2742, 2743.

a situation in which one or a few factors stressed the market; rather, it was an unprecedented situation in which numerous adverse events occurred simultaneously to place California and the entire West in an electricity crisis that had never before been experienced.⁴²

These problems placed utilities with an obligation to serve retail customers in the unenviable position of having to choose between purchasing high-priced electricity in the volatile spot markets or entering into long-term contracts at fixed rates that were “very high by historical standards”⁴³ but would protect them against future price increases and provide a stable source of future energy. Anticipating continued spot market instability, many utilities chose the long-term contract option. In binding themselves to fixed rates over the long term, both the buyers and the sellers took substantial, calculated risks—buyers risked that spot prices would fall below the fixed forward prices they had agreed to pay; sellers risked that spot prices would continue to rise, increasing supply costs and the opportunity cost of forward contracts.⁴⁴ Less than a year into the contracts, spot prices in fact declined significantly, and the forward contract prices therefore became substantially higher than the prices the buyers could obtain in the spot markets. Instead of assuming the responsibility to pay those higher prices to which they had expressly agreed, many buyers rushed to file complaints at FERC alleging that their contract rates were “unjust and unreasonable” under the FPA, and should be abrogated or modified.⁴⁵

Notably, the backdrop of the western energy crisis provided the buyers and their supporters with substantial ammunition. Beyond the sheer magnitude of the price increases in the spot markets during

⁴² *Californians for Renewable Energy, Inc. v. Cal. Pub. Utils. Comm’n*, 119 F.E.R.C. ¶ 61,058, at 61,246 (2007). See also James L. Sweeney, *The California Electricity Crisis* (Hoover Press 2002) (discussing the factors contributing to the energy crisis).

⁴³ *Morgan Stanley*, 128 S. Ct. at 2743.

⁴⁴ In addition, some of the sellers in *Morgan Stanley* purchased power to meet their contract obligations at prices that were comparable to the contract rates. See *Nevada Power Initial Order*, 103 F.E.R.C. ¶ 61,353, at 62,393.

⁴⁵ *Morgan Stanley* itself resulted from complaints filed with FERC by Public Utility District No. 1 of Snohomish County, Washington, Nevada Power Company, Sierra Pacific Power Company, and Southern California Water Company seeking to abrogate or modify their respective contracts.

the energy crisis, FERC found certain of the spot markets in California to have been “dysfunctional.”⁴⁶ And it was later discovered that Enron and other sellers had attempted to manipulate those spot markets.⁴⁷ The buyers argued that the dysfunction in the spot markets tainted the forward contract offers they received, because long-term contracts are priced at the rates parties anticipate for future spot market sales. And that intuition was bolstered by a report prepared by FERC staff (though not officially adopted by the agency), which concluded that there was a statistical correlation between spot and forward prices.⁴⁸ The buyers also argued that the “dysfunctional” California spot markets left them no practical alternative but to enter into the challenged contracts to serve their retail customers, who would ultimately bear the burden of the high contract rates.⁴⁹

After an evidentiary hearing, FERC rejected the complaints.⁵⁰ At the threshold, the Commission concluded that the public interest

⁴⁶ See, e.g., *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 F.E.R.C. ¶ 61,121, at 61,349 (2000) (finding centralized auction markets administered by the California Independent System Operator and California Power Exchange to have been “dysfunctional”).

⁴⁷ See *Pub. Utils. Comm’n of Cal. v. FERC*, 462 F.3d 1027, 1039–40 (9th Cir. 2006); *Enron Power Mktg., Inc.*, 103 F.E.R.C. ¶ 61,343 (2003) (finding Enron to have engaged in market manipulation and imposing penalties), reh’g denied, 106 F.E.R.C. ¶ 61,024 (2004).

⁴⁸ See Staff of the Federal Energy Regulatory Commission, *Final Report on Price Manipulation in Western Markets, Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices*, Docket No. PA02-2-000, at Chapter V (Mar. 26, 2003).

⁴⁹ Even though states retain their jurisdiction over retail sales and may require public utilities subject to their jurisdiction to enter only into prudent purchases, they may not prevent a public utility from passing through to its retail customers the wholesale rates approved by FERC. See, e.g., *Entergy La., Inc. v. La. Pub. Serv. Comm’n*, 539 U.S. 39, 41–42 (2003) (“FERC-approved cost allocations . . . may not be subjected to reevaluation in state ratemaking proceedings.”); *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 962 (1986) (“[I]nterstate power rates filed with FERC or fixed by FERC must be given binding effect by state utility commissions determining intrastate rates.”).

⁵⁰ See *Nevada Power Initial Order*, 103 F.E.R.C. ¶ 61,353, reh’g denied, *Nevada Power Rehearing Order*, 105 F.E.R.C. ¶ 61,185. See also *Pub. Utils. Comm’n of Cal. v. Sellers of Long Term Contracts to the Cal. Dep’t. of Water Resources*, 103 F.E.R.C. ¶ 61,354 (2003) (rejecting complaints by the California Public Utilities Commission and the California Electricity Oversight Board seeking to abrogate or modify contracts entered into by the California Department of Water Resources), reh’g denied, 105

standard applies to all the challenged contracts and rejected many of the buyers' attempts to distinguish the case from *Mobile* and *Sierra*. For example, the buyers had argued that, unlike *Mobile* and *Sierra*, which involved attempts by sellers to raise rates for their own benefit, they were attempting to lower prices for the ultimate benefit of retail customers. Along the same lines, some intervenors had argued that their challenges should not be treated as if they were parties who had agreed to the contracts, because they were state representatives acting to protect the interests of the consuming public. The Commission held that under *Mobile-Sierra* it "is no more at liberty to alter a contract 'to the prejudice of the producers than to do so in their favor,'"⁵¹ and that no "precedent . . . supports a finding that a non-signatory party may challenge a *Mobile-Sierra* contract under the 'just and reasonable' standard of review, as opposed to the 'public interest' standard of review."⁵²

In one important respect, however, the Commission apparently agreed with the buyers. As a result of various technological advancements and regulatory initiatives, the electric industry has moved from one dominated by a small number of large, vertically integrated utilities to one with numerous independent electric generators and in which all market participants have the ability to obtain transmission rights on a non-discriminatory basis.⁵³ In line with these developments, FERC has moved away from a scheme of cost-based ratemaking (where a seller must justify its price as a recovery of costs plus a reasonable rate of return) to a market-based rate regime (where sellers who demonstrate they lack market power are granted blanket authority to make sales at negotiated rates). Although market-based rate sellers are still subject to certain ongoing reporting requirements to ensure that they cannot exert market dominance, their individual contracts do not have to be filed with or reviewed by FERC before

F.E.R.C. ¶ 61,182 (2003); *Pacificorp v. Reliant Energy Servs., Inc.*, 103 F.E.R.C. ¶ 61,355 (2003) (rejecting complaints by Pacificorp against five sellers).

⁵¹ Nevada Power Rehearing Order, 105 F.E.R.C. ¶ 61,185, at 61,985 (quoting *Pub. Serv. Comm'n of New York v. FPC*, 543 F.2d 757, 798 (D.C. Cir. 1974)).

⁵² Nevada Power Initial Order, 103 F.E.R.C. ¶ 61,353, at 62,389 (citations omitted).

⁵³ See *Morgan Stanley*, 128 S. Ct. at 2740–41 (describing competitive advances in the industry); *Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Servs. by Pub. Utils.*, 61 Fed. Reg. 21,540 (May 10, 1996) (FERC rulemaking requiring transmission to be provided on a non-discriminatory basis).

becoming effective.⁵⁴ Because the challenged western energy crisis contracts were all market-based, they had not been filed with FERC. These contracts were therefore distinguishable, the buyers argued, from the contracts in *Mobile* and *Sierra*, which had been filed with and accepted by the Commission. How, the buyers essentially asked, can FERC be expected to satisfy its regulatory responsibilities under the FPA to ensure that all rates are “just and reasonable” if contracts that are not reviewed at all before becoming effective are later essentially immune to challenge as a result of *Mobile-Sierra*’s “practically insurmountable” public interest standard?

FERC did not contest that the public interest standard only applies to contracts that have been filed with and subject to review by the Commission. In FERC’s view, however, any prior-review requirement was satisfied through its market-based regime. Specifically, FERC asserted that “[t]he need for prior Commission review . . . was met when, after determining that the [sellers] lacked market power or had taken steps to mitigate it, the Commission authorized all of the [sellers] in this proceeding to make sales of power at market-based rates.”⁵⁵ FERC explained that it “is not required specifically to review each agreement since the Commission, when it grants umbrella market-based rate authorization, pre-determines that rates under future contracts entered into pursuant to the market-based rate authorization will be just and reasonable.”⁵⁶

Having found the public interest standard applicable, the Commission concluded that the buyers failed to show that contract modification was required by the public interest. Pointing to the factors identified in *Sierra*, the Commission found “no credible record evidence that the contracts at issue are placing the [buyers] in financial distress so as to threaten their ability to continue service,” that “other customers will bear an excessive burden as a result of upholding the challenged contracts,” or that “the contracts terms are unduly discriminatory.”⁵⁷ In addition, after examining the “totality of circumstances preceding and following the execution of the contracts

⁵⁴ See *Morgan Stanley*, 128 S. Ct. at 2741–42 (describing FERC’s market-based regime).

⁵⁵ *Nevada Power Initial Order*, 103 F.E.R.C. ¶ 61,353, at 62,388 (footnotes and citation omitted).

⁵⁶ *Id.* at 62,389.

⁵⁷ *Id.* at 62,397.

at issue,”⁵⁸ the Commission concluded that the contracts “were the result of choices voluntarily made by the [buyers] and to the extent the [buyers] left themselves open to unnecessary risks, it was also their choice.”⁵⁹ Allowing a party that “suddenly finds that its deal has become uneconomical” to undo its voluntary bargains is forbidden under the *Mobile-Sierra* doctrine and would create “uncertainty in the market”⁶⁰ that, in turn, would “erode investor confidence and willingness to invest in merchant energy projects, which . . . could have an adverse effect on infrastructure development, especially at a time when western markets need new generation and transmission.”⁶¹ Rejecting the complaints was “in the public interest because it balances effective rate regulation with respect for the sanctity of contracts, as dictated by the U.S. Supreme Court under the *Mobile-Sierra* doctrine.”⁶²

IV. The Ninth Circuit Limits *Mobile-Sierra* and Imposes Layers of Agency Regulation on Private Contracts

The Ninth Circuit rejected FERC’s conclusions.⁶³ The court of appeals characterized *Mobile* and *Sierra* as creating a presumption that a negotiated contract is “just and reasonable” only if FERC had an opportunity to review the contract for justness and reasonableness before it went into effect. The Ninth Circuit did not believe that condition was satisfied here because FERC’s market-based regime does not provide for Commission review of individual contracts and only requires periodic reporting to ensure that sellers lack market power. In the Ninth Circuit’s view, FERC’s market-based rate regime is insufficient to ensure just and reasonable rates because it “precludes timely consideration of sudden market changes and offers no protection to purchasers victimized by the abuses of sellers

⁵⁸ *Id.* at 62,398.

⁵⁹ *Id.* at 62,399.

⁶⁰ Nevada Power Rehearing Order, 105 F.E.R.C. ¶ 61,185, at 61,982–83.

⁶¹ Nevada Power Initial Order, 103 F.E.R.C. ¶ 61,353, at 62,393 (describing findings of the Administrative Law Judge).

⁶² *Id.* at 62,384.

⁶³ See *Snohomish*, 471 F.3d at 1077; see also *Pub. Utils. Comm’n of Cal. v. FERC*, 474 F.3d 587 (9th Cir. 2006) (granting petitions for review of FERC’s orders rejecting complaints by California state agencies based on the reasoning in *Snohomish*).

or dysfunctional market conditions that FERC itself only notices in hindsight.”⁶⁴

Although the Ninth Circuit’s decision did not bind FERC to cost-based ratemaking, it effectively stripped market-based contract rates of any protection against future challenges. The court held that, in the context of market-based contracts, the *Mobile-Sierra* presumption would only apply in “limited circumstances” where three “prerequisites” were satisfied: (1) the contract, by its terms, cannot preclude the application of the *Mobile-Sierra* public interest standard; (2) “the regulatory scheme in which the contracts are formed must provide FERC with an opportunity for initial review of the contracted rate”;⁶⁵ and (3) “the scope of that review must permit consideration of the factors relevant to the propriety of the contract’s formation”⁶⁶—retroactively, if necessary. The court’s first prerequisite simply reflected the preexisting understanding that contracting parties may choose to opt-out of the public interest standard.⁶⁷ The second and third prerequisites, however, would have resulted in a radical expansion of FERC’s regulatory authority over private contracts. In effect, these prerequisites would have negated *any* “presumption” of justness and reasonableness by requiring *de novo* substantive FERC review of the justness and reasonableness of every contract, including a full investigation of whether any exogenous factors had affected the parties’ bargain. The court reasoned that, unless the second and third prerequisites were met, “FERC’s reliance on the [*Mobile-Sierra*] presumption would amount to a complete abdication of its statutory responsibility under the FPA.”⁶⁸

In addition, even if *Mobile-Sierra* were found to be applicable to the buyers’ claims, the Ninth Circuit found that FERC had applied “an erroneous standard for determining whether the challenged contracts affect the public interest.”⁶⁹ The court held that the Commission erred in giving these contracts the same deference they would have been owed if challenged by a seller seeking to raise

⁶⁴ *Snohomish*, 471 F.3d at 1085.

⁶⁵ *Id.* at 1076.

⁶⁶ *Id.* at 1077.

⁶⁷ See *supra* note 32.

⁶⁸ *Snohomish*, 471 F.3d at 1075.

⁶⁹ *Id.* at 1087.

the rates. Because the Commission's primary responsibility is the protection of consumers, the court ruled that contract rates should receive no significant deference when challenged by a buyer seeking lower rates that would be passed on to its retail customers. The court instructed the Commission that "if a challenged contract imposes any significant cost on ultimate customers because of a wholesale rate too high to be within a zone of reasonableness, that contract affects the public interest."⁷⁰ And the court specified that rates will generally be within the "zone of reasonableness" only if they approximate marginal costs.⁷¹

The sellers sought Supreme Court review. Their efforts were supported by leading industry groups and economists who believed that, unless reversed, the Ninth Circuit's decision would endanger the nation's stable and efficient supply of electricity and inflict substantial harm on the electric and natural gas industries, and the economy in general. The Commission opposed Supreme Court review—which is hardly surprising because the Ninth Circuit's decision would have vastly expanded its regulatory authority to second-guess and modify contracts. Once certiorari was granted, however, FERC stepped up to defend its orders.

V. *Morgan Stanley*: The Supreme Court Reaffirms the Application of Traditional Contract Principles

The Supreme Court squarely repudiated the Ninth Circuit's limitations on *Mobile-Sierra* and, for the authors and others who have been involved in contract disputes before FERC, the Court's decision in *Morgan Stanley* heralds a welcome return to the basic concept that a deal is a deal. The Court's opinion reaffirms two principles crucial to contract stability: First, that rates agreed to in freely negotiated contracts should be presumed just and reasonable, and second, that regardless of whether they are challenged as too low or too high, *Mobile-Sierra* contract rates are immune from regulatory interference by FERC except in extraordinary circumstances.

⁷⁰ *Id.* at 1089 (citation omitted). See also *Pub. Utils. Comm'n of Cal. v. FERC*, 474 F.3d at 596 (finding the public interest to be affected "[e]ven if rates did not increase . . . [if] the retail rates charged consumers because of these contracts might have been higher than they would have been had the wholesale contract rates been lower").

⁷¹ *Snohomish*, 471 F.3d at 1089.

At the outset, Justice Scalia, writing for the Court, squarely rejected the notion that the *Mobile-Sierra* doctrine is itself unlawful. As previously explained, the Commission and various courts have stated that *Mobile-Sierra* contract rates can only be modified if the “public interest standard” is satisfied, while characterizing other rates as subject to modification under a less demanding “just and reasonable standard.” Capitalizing on this confusing nomenclature, some buyers insisted that *Mobile* and *Sierra* erred in ignoring the statutory requirement that all rates must be “just and reasonable.” The Court agreed with the buyers that “[t]here is only one statutory standard for assessing wholesale electricity rates, whether set by contract or tariff—the just and reasonable standard”⁷²—but explained that *Mobile-Sierra* merely “provide[s] a definition of what it means for a rate to satisfy the just-and-reasonable standard in the contract context.”⁷³

The Court also rejected the Ninth Circuit’s attempt to premise the application of *Mobile-Sierra* on FERC having initially determined upon a contract’s filing that its rates are just and reasonable, as though the doctrine were merely a form of regulatory estoppel. The Court made clear that, regardless of *when* the Commission is asked to review a contract,⁷⁴ FERC must “presume that the rate set out in a freely negotiated wholesale-energy contract meets the ‘just and reasonable’ requirement imposed by law,”⁷⁵ and that this presumption “may be overcome only if FERC concludes that the contract seriously harms the public interest.”⁷⁶

These holdings are neither new law nor new limitations on the Commission’s authority. They spring naturally from the Court’s earlier recognition that the FPA and NGA were not intended to circumscribe a party’s fundamental right to “establish *ex parte*, and change at will, the rates offered to prospective customers; or to fix by contract, and change only by mutual agreement, the rate

⁷² Morgan Stanley, 128 S. Ct. at 2745.

⁷³ *Id.* at 2746.

⁷⁴ *Id.* at 2745.

⁷⁵ *Id.* at 2737.

⁷⁶ *Id.*

agreed upon with a particular customer.”⁷⁷ In this respect, the FPA and NGA are dramatically different from schemes, like the now-overhauled Interstate Commerce Act,⁷⁸ that were intended to regulate the relationships between a dominant service provider and the public at large and therefore required a one-size-fits-all tariffing approach. By contrast, the wholesale power business regulated by FERC has always been characterized by “sophisticated businesses enjoying presumptively equal bargaining power, who can be expected to negotiate a ‘just and reasonable’ rate as between the two of them.”⁷⁹

Thus, the Court found it hardly surprising that Congress would have “departed from the scheme of purely tariff-based regulation and acknowledged that contracts between commercial buyers and sellers could be used in rate setting.”⁸⁰ In a regulatory scheme grounded on the ability of “sophisticated businesses” to manage their own affairs and protect their own interests, there is no need for FERC to have an initial opportunity for plenary review before presuming that contract rates are just and reasonable. By concluding that contract rates should be presumed to be just and reasonable regardless of the opportunity for prior agency review, the Court’s decision rightly prohibits the Commission from adopting a paternalistic approach that would constrain parties to agreements that are based on a traditional cost-based approach. *Morgan Stanley* upholds contracting freedoms by recognizing that the voluntary agreement of parties can substitute for the cost analysis that is generally used to initially assess the justness and reasonableness of unilateral rates.

⁷⁷ *United Gas Pipe Line Co. v. Mobile Gas Servs. Corp.*, 350 U.S. 332, 343 (1956); see also *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968) (“The regulatory system created by the Act is premised on contractual agreements voluntarily devised by the regulated companies.”).

⁷⁸ Interestingly, in rewriting the scheme for regulation of rail transportation under the Interstate Commerce Act, Congress expressly permitted parties to enter into contracts for rail transportation services and removed such contracts from agency supervision. See 49 U.S.C. § 10709(c).

⁷⁹ *Verizon Commc’ns, Inc. v. FCC*, 535 U.S. 467, 479 (2002). In contrast, limitations on the right to contract have often been upheld based on the need to protect contracting parties that are disadvantaged or in inferior bargaining positions. See, e.g., *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937) (upholding minimum wage laws intended to protect workers that lack bargaining power).

⁸⁰ *Verizon*, 535 U.S. at 479.

At the same time, the Court appreciated that prices set in wholesale electricity contracts may adversely affect the consumers who will ultimately be asked to bear those rates, and acknowledged that the FPA is intended, in part, “to protect power consumers against excessive prices”⁸¹ and “against exploitation at the hands of” sellers.⁸² Navigating between the market and regulatory paradigms, *Morgan Stanley* confirms FERC’s power to “abrogate a valid contract . . . if it harms the public interest.”⁸³ In this way, the Court’s decision simply reflects the long-held understanding that “freedom of contract is the general rule and restraint the exception. The exercise of legislative authority to abridge it can be justified only by the existence of *exceptional circumstances*.”⁸⁴

Although the Court thus strongly reaffirmed the continued viability of the *Mobile-Sierra* doctrine, it nonetheless remanded the case to FERC for further consideration because it found FERC’s analysis of the public interest lacking in two respects. First, the Court found that FERC had failed adequately to consider “whether the contracts imposed an excessive burden on consumers ‘down the line,’ relative to the rates they could have obtained (but for the contracts) after elimination of the dysfunctional market.”⁸⁵ Second, the Court directed FERC to consider whether “one party to a contract engaged in such extensive unlawful market manipulation” that the contract would not be presumed to be “just and reasonable,”⁸⁶ but made it clear that contract modification for that reason would only be

⁸¹ *Pennsylvania Water & Power Co. v. FPC*, 343 U.S. 414, 418 (1952).

⁸² *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944).

⁸³ *Morgan Stanley*, 128 S. Ct. at 2747. *Morgan Stanley* also leaves untouched basic contract principles by explicitly recognizing that the *Mobile-Sierra* presumption would not apply “where there is unfair dealing at the contract formation stage—for instance, if [there are] traditional grounds for the abrogation of the contract such as fraud or duress.” *Id.*

⁸⁴ *Advance-Rumely Thresher Co. v. Jackson*, 287 U.S. 283, 288 (1932) (emphasis added) (citations omitted). See also *Steele v. Drummond*, 275 U.S. 199, 205 (1927) (“It is only because of the dominant public interest that one, who has had the benefit of performance by the other party, is permitted to avoid his own obligation on the plea that the agreement is illegal. And it is a matter of great public concern that freedom of contract not be lightly interfered with.” (citations omitted)).

⁸⁵ *Morgan Stanley*, 128 S. Ct. at 2749–50.

⁸⁶ *Id.* at 2750.

warranted if there was “a causal connection between unlawful activity and the contract rate.”⁸⁷

In remanding for an analysis of those issues, however, the Court made it clear that the Commission’s public interest analysis must give heavy weight to the integrity of contracts that is necessary to ensure a stable and sufficient supply of electricity. It squarely rejected the Ninth Circuit’s view that FERC should be less deferential to a contract when the contract rate is being challenged by the buyer as too high. The Court explained that, by requiring FERC to assess the public impact of contract rates with reference to marginal cost, the Ninth Circuit had negated *Mobile-Sierra*’s presumption of validity and “restitut[ed] cost-based rather than contract-based regulation.”⁸⁸ In order to “accord an adequate level of protection to contracts,” the Court made it clear that “[t]he standard for a buyer’s rate-increase challenge must be the same . . . as the standard for a seller’s challenge: The contract rate must seriously harm the public interest.”⁸⁹

As mentioned before, the justness and reasonableness of tariff rates are traditionally assessed by reference to cost, with the seller permitted only to recover its cost plus a regulated rate of return. By contrast, under *Mobile-Sierra*, contract rates are presumptively just and reasonable and do not harm the public interest simply because they exceed cost. The Court emphasized in *Morgan Stanley* that the public interest standard is a “high one” which requires a showing of “something more than a small dent in the consumer’s pocket.”⁹⁰ There is nothing radical about the concept that “the ordinary mode for evaluating contractually set rates is to look to whether the rates seriously harm the public interest, not to whether they are unfair to one of the parties that voluntarily assented to the contract.”⁹¹ The law has long recognized that the exercise of the right to contract

⁸⁷ *Id.* at 2751.

⁸⁸ *Id.* at 2748.

⁸⁹ *Id.* at 2747. Unlike the Ninth Circuit, the D.C. Circuit has also refused to distinguish between buyers and sellers, holding the *Mobile-Sierra* doctrine to be equally applicable in challenges brought by buyers as well as by sellers. See, e.g., *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403 (D.C. Cir. 2000); *San Diego Gas & Elec. Co. v. FERC*, 904 F.2d 727 (D.C. Cir. 1990).

⁹⁰ *Morgan Stanley*, 128 S. Ct. at 2749 n.6.

⁹¹ *Id.* at 2746 (citation omitted).

will always “in some respect, however slight, affect the public,”⁹² and “the mere declaration by a Legislature that a business is affected with a public interest is not conclusive of the question whether its attempted regulation on that ground is justified.”⁹³ Indeed, the Court recognized long before *Mobile* and *Sierra* that “[t]he power to fix rates, when exerted, is for the public welfare, to which private contracts must yield; but it is not an independent legislative function to vary or set aside such contracts, however unwise and unprofitable they may be. Indeed, the exertion of legislative power solely to that end is precluded by the contract impairment clause of the Constitution.”⁹⁴

Instead of the marginal cost-based, “zone of reasonableness” analysis contemplated by the Ninth Circuit, which focuses solely on short-term concerns, the Court directed the Commission to adopt a long-term view and consider whether the contracts imposed an excessive burden on consumers “down the line.”⁹⁵ The dissent complained that this directive improperly interfered with the Commission’s discretion to “balanc[e] the short-term and long-term interests of consumers.”⁹⁶ The Court’s holding, however, seems—at least to us—to be a natural consequence of Congress’s express contemplation of private contracts in the FPA and NGA. After all, requiring contract modification any time the contract rate exceeds or falls below cost would, in essence, represent “a reinstatement of cost-based rather than contract-based regulation.”⁹⁷ If there is to be any room under the FPA and NGA for contracts, there must be times when it is acceptable for “short-term rates for a subset of the public [to] be high by historical standards.”⁹⁸ Indeed, because costs will invariably change over time, FERC has traditionally assessed “the justness and

⁹² *Nebbia v. State of New York*, 291 U.S. 502, 524–25 (1934).

⁹³ *Chas. Wolff Packing Co. v. Court of Industrial Relations of Kansas*, 262 U.S. 522, 536 (1923).

⁹⁴ *Ark. Natural Gas Co. v. Ark. R.R. Comm’n*, 261 U.S. 379, 383 (1923).

⁹⁵ *Morgan Stanley*, 128 S. Ct. at 2750.

⁹⁶ *Id.* at 2756 (Stevens, J., dissenting).

⁹⁷ *Id.* at 2748 (majority opinion). As the Court observed, a cost-based standard for assessing contracts would also subject the Commission to the “onerous new burden” of having to conduct detailed analyses any time it was alleged that costs had risen or fallen. See *id.* at 2749.

⁹⁸ *Id.*

reasonableness of long-term contracts and their rates over the ‘life-of-the-contract’ rather than on a ‘snapshot-in-time’ basis, looking at the benefits and burdens over the full-term of the contract.”⁹⁹

Further, the long-term approach adopted by the Court is necessary for any rational view of the public interest. The Court correctly recognized that “contract stability ultimately benefits consumers,”¹⁰⁰ and that the shortsighted standard the Ninth Circuit sought to impose would undermine “the important role of contracts in the FPA, as reflected in . . . *Sierra*, and would threaten to inject more volatility into the electricity market by undermining a key source of stability.”¹⁰¹ Although consumers and their representatives will often seek the lowest current rates possible, imposing a regulatory cost-based cap on contracts would “have a chilling effect on investments and a seller’s willingness to enter into long-term contracts and this, in turn, can harm customers in the long run.”¹⁰²

The particular characteristics of the electric industry render contractual stability especially important to the public—and consumer—welfare. As prominent economists explained in an amicus brief in support of the sellers in *Morgan Stanley*,¹⁰³ electricity is a commodity that cannot be stored, making it particularly susceptible to price swings due to changes in demand or in prices of inputs to generation (such as natural gas). The ability to enter into long-term electricity contracts therefore provides parties with a critically needed tool to hedge against future market fluctuations. And, of course, these contracts can fulfill their stabilizing and risk-management functions only if they are enforceable. In addition, the electric industry is highly capital intensive, requiring large infusions of investment in order to meet growing demand as well as to replace aging infrastructure. In light of the move to competitive wholesale markets, however, power generators and marketers have no regulatory guarantees that they will be provided a reasonable opportunity

⁹⁹ *N. Va. Elec. Coop., Inc. v. Old Dominion Elec. Coop.*, 116 F.E.R.C. ¶ 61,173, at 61,741 (2006) (citation omitted).

¹⁰⁰ *Morgan Stanley*, 128 S. Ct. at 2749.

¹⁰¹ *Id.*

¹⁰² *Id.* (citation omitted).

¹⁰³ See Brief of William J. Baumol, et al., as Amici Curiae in Support of Petitioners, *Morgan Stanley*, 128 S. Ct. 2733 (Nov. 2007) (Nos. 06-1457, 06-1462), 2007 WL 4232926 (“Economists’ Brief”).

to recover their costs. Enforceable long-term contracts provide an assured revenue source that helps ensure investments for the long-term benefit of the public. As FERC itself recognized in its underlying order, “[c]ompetitive power markets simply cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty, including certainty that the Commission will not modify market-based contracts unless there are extraordinary circumstances.”¹⁰⁴

The Court also properly refused to exempt these cases from the strictures of *Mobile-Sierra* because of the extraordinary market upheavals caused by the western energy crisis. The Court held that “the mere fact that a market is imperfect, or even chaotic, is no reason to undermine the stabilizing force of contracts that the FPA embraced.”¹⁰⁵ The Court emphasized that contracts are an important stabilizing force, particularly during times of market volatility, and that “[i]t would be a perverse rule that rendered contracts less likely to be enforced when there is volatility in the market.”¹⁰⁶ The Court recognized, moreover, that markets are, by their nature, not “perfect,”¹⁰⁷ and that a party entering into a contract will never have a full understanding of all the factors affecting current prices or how these may change during the life of the contract. Indeed, many of these factors—for example, supply, demand, and the price of inputs—will be beyond the contracting parties’ control. But it is for precisely these reasons that contracts are needed as a risk-allocation mechanism. By contrast, the Ninth Circuit’s concept of regulation premised on a hindsight review of all factors potentially relevant to “the propriety of the contract’s formation”¹⁰⁸ would undermine parties’ attempts to allocate market risks among themselves.

¹⁰⁴ *Nev. Power Co. v. Duke Energy Trading & Mktg., L.L.C.*, 99 F.E.R.C. ¶ 61,047, at 61,190 (2002).

¹⁰⁵ *Morgan Stanley*, 128 S. Ct. at 2747.

¹⁰⁶ *Id.* at 2746.

¹⁰⁷ *Id.*

¹⁰⁸ *Snohomish*, 471 F.3d at 1061.

The Court also appropriately recognized that “evaluating market ‘dysfunction’ is a very difficult and highly speculative task.”¹⁰⁹ In the western energy crisis, for example, it is not (and likely never will be) clear the extent to which forward price increases may have been caused by spot market manipulation as compared with other “legitimate” factors, such as increased demand and constrained supply.¹¹⁰ Moreover, there are instances where even acknowledged “dysfunction” would not justify contract modification. For example, and as the Economists’ Brief pointed out to the Court, “OPEC routinely engages in anticompetitive conduct that would violate U.S. antitrust laws, and that indisputably distorts energy markets.”¹¹¹ Yet OPEC’s monopoly power over oil prices would hardly provide a valid reason for overturning energy contracts. After all, the owner of an oil-fired generating facility would equally be the “victim” of oil prices as the buyer of the power. But under the Ninth Circuit’s directive, FERC would have to decide that such “factors exogenous to the forward market”¹¹² constitute a valid basis for contract modification. *Morgan Stanley* avoids this murky and open-ended inquiry by applying traditional contract principles: The Commission is only required to determine if there was “unfair dealing at the contract formation stage”—that is, wrongdoing by a contracting party that directly affected the contract.¹¹³

¹⁰⁹ *Morgan Stanley*, 128 S. Ct. at 2747. Notably, even in the context of cost-based rates, it is acknowledged that FERC is not able or required to arrive at “perfect” rates. See, e.g., *Cities of Batavia v. FERC*, 672 F.2d 64, 84 (D.C. Cir. 1982) (“[T]he billing design need only be reasonable, not theoretically perfect.”); *Town of Norwood v. FERC*, 53 F.3d 377, 380 (D.C. Cir. 1995) (“Long-range estimates are an integral feature of ratemaking and financial analysis in general, and we have regularly approved reliance on admittedly imperfect future cost estimates.”); *Tenneco Oil Co. v. FERC*, 571 F.2d 834, 841 (5th Cir. 1978) (“Administrative expedience, the pursuit of the achievable rather than the perfect, provides a reasoned basis for the Commission’s judgment”).

¹¹⁰ Compare Scott M. Harvey & William W. Hogan, *Market Power and Market Simulations* (2002) (available at http://www.hks.harvard.edu/hepg/Papers/Hogan_Harvey_Market_Power&Simulations_071602.pdf), with Paul L. Joskow & Edward Kahn, *A Quantitative Analysis of Pricing Behavior in California’s Wholesale Electricity Market During Summer 2000*, 23 *Energy J.* 1 (2002).

¹¹¹ Economists’ Brief, *supra* note 103, at 27.

¹¹² *Snohomish*, 471 F.3d at 1086.

¹¹³ As discussed, pursuant to this analysis, the Court directed FERC, on remand, to consider whether market manipulation by any of the sellers had adversely affected the contract rates. *Morgan Stanley*, 128 S. Ct. at 2747, 2750–51.

VI. Implications of *Morgan Stanley* for FERC's Future Regulation of Electricity and Natural Gas Contracts

A. *Morgan Stanley* Requires Use of the Public Interest Standard for Third-Party Challenges

In its underlying order, in which it rejected intervenors' arguments that *Mobile-Sierra* does not apply to third-party challenges, FERC explained that there was no precedent exempting non-contracting parties from the public interest standard.¹¹⁴ That is consistent with numerous cases in which courts have required the Commission to use the public interest standard even where it is acting *sua sponte*, rather than at the behest of one of the contracting parties.¹¹⁵ But in *Maine Public Utilities Commission v. FERC*,¹¹⁶ issued just before *Morgan Stanley* was decided, a panel of the D.C. Circuit departed from that precedent. *Maine PUC* held that the Commission cannot approve an agreement "that applies the highly-deferential 'public interest' standard to rate challenges brought by non-contracting third parties."¹¹⁷ The D.C. Circuit read the *Mobile-Sierra* doctrine as only applying "when 'one party to a rate contract on file with FERC attempts to effect a unilateral rate change by asking FERC to relieve its obligations under a contract whose terms are no longer favorable to that party.'"¹¹⁸ Thus, the court reasoned, the doctrine cannot "deprive [third parties] of their statutory right to challenge rates under the 'just and reasonable' standard."¹¹⁹

Based on *Maine PUC*, FERC issued a string of orders adopting the view that contracting parties cannot bind third parties to the stringent public interest standard under *Mobile-Sierra*, and that the Commission has the authority to outright reject contract language

¹¹⁴ See Nevada Power Initial Order, 103 F.E.R.C. ¶ 61,353, at 62,389.

¹¹⁵ See, e.g., *Ne. Utils. Serv. Co. v. FERC*, 993 F.2d 937 (1st Cir. 1993); *Boston Edison Co. v. FERC*, 233 F.3d 60 (1st Cir. 2000).

¹¹⁶ 520 F.3d 464 (D.C. Cir. 2008).

¹¹⁷ *Id.* at 477.

¹¹⁸ *Id.* at 478 (quoting *Me. Pub. Util. Comm'n v. FERC*, 454 F.3d 278, 284 (D.C. Cir. 2006)).

¹¹⁹ *Id.* at 476.

purporting to do so.¹²⁰ In light of *Morgan Stanley*, however, FERC now has apparently reversed course, and it recently sought rehearing of *Maine PUC's* third-party exemption¹²¹ over the vociferous objections of certain FERC commissioners.¹²² In our view, FERC now has it right, as the reasoning in *Morgan Stanley* squarely precludes the notion that third parties are exempt from *Mobile-Sierra*.

The Supreme Court made it clear in *Morgan Stanley*, when rejecting the Ninth Circuit's initial-review "prerequisite," that FERC is required to apply the public interest standard whenever it reviews contracts, even in the first instance, because rates freely negotiated by contracting parties are presumed to be just and reasonable under the FPA.¹²³ As the Court explained, the *Mobile-Sierra* doctrine is "grounded in the commonsense notion that '[i]n wholesale markets, the party charging the rates and the party charged [are] often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them.'"¹²⁴ "Therefore," the Court explained, "only when the mutually agreed-upon contract rate seriously harms the consuming public may the Commission declare it not to be just and reasonable."¹²⁵ The Court's explanation of why *Mobile-Sierra*

¹²⁰ See, e.g., *Entergy Servs., Inc.*, 124 F.E.R.C. ¶ 61,100, at ¶ 3 (2008); *PJM Interconnection, L.L.C.*, 124 F.E.R.C. ¶ 61,105, at ¶ 21 (2008); *Westar Energy, Inc.*, 123 F.E.R.C. ¶ 61,252, at ¶ 21 (2008); *Duke Energy Carolinas, LLC*, 123 F.E.R.C. ¶ 61,201, at 62,290 n.10 (2008).

¹²¹ See Petition of Respondent Federal Energy Regulatory Commission for Panel Rehearing and Suggestion for Rehearing En Banc, *Me. Pub. Utils. Comm'n v. FERC*, Nos. 06-1403 and 07-1193 (D.C. Cir. Aug. 8, 2008).

¹²² Commissioners Kelly and Wellinghoff dissented from FERC's decision to seek rehearing of *Maine PUC*. Dissenting opinion available at <http://www.ferc.gov/about/com-mem/kelly/8-08-08-maine-PUC.pdf>. In the wake of *Morgan Stanley*, Commissioners Kelly and Wellinghoff concede that the public interest test applies to voluntary bilateral agreements but continue to believe that in some circumstances—in *Maine PUC* itself, an agreement in settlement of a rate dispute—the less deferential just and reasonable standard should apply to any contract modifications sought by non-signatories. See *id.*; see also, e.g., *Entergy Servs., Inc.*, 124 F.E.R.C. ¶ 61,100, at 61,562 (2008) (Wellinghoff and Kelly, Commissioners, dissenting); *PJM Interconnection, L.L.C.*, 124 F.E.R.C. ¶ 61,105, at 61,607 (2008) (Wellinghoff and Kelly, Commissioners, dissenting); *Consumers Energy Co.*, 124 F.E.R.C. ¶ 61,093, at 61,519-20 (2008) (Wellinghoff and Kelly, Commissioners, dissenting).

¹²³ *Morgan Stanley*, 128 S. Ct. at 2745.

¹²⁴ *Id.* (quoting *Verizon*, 535 U.S. at 479 (alterations in original)).

¹²⁵ *Id.*

applies regardless of *when* a contract rate is challenged equally explains why the doctrine applies regardless of *by whom* a contract rate is challenged. A rate that is presumed just and reasonable because it was freely negotiated does not lose that quality when challenged by non-contracting third parties.

Applying the *Mobile-Sierra* presumption to third-party challenges is also the only sensible rule in the circumstances. Because the FPA governs the interstate transmission and sale of electric energy at wholesale,¹²⁶ every contract reviewed by FERC will affect third party retail customers down the line, and there will accordingly always be some nonparty who would be willing to act as a surrogate for the buyer. *Mobile-Sierra* would therefore provide no real protection for contracts if the public interest test were not applicable to such indirect challenges. At the same time, because the public interest analysis mandated by *Mobile, Sierra*, and *Morgan Stanley* by definition takes into consideration the effect of a contract on others, there is no basis for asserting that the uniform application of the doctrine disenfranchises third parties. Applying the *Mobile-Sierra* doctrine in no way curtails the Commission's ability to act for "the protection of the public interest, as distinguished from the private interests of the utilities."¹²⁷

B. The Justness and Reasonableness of Freely Negotiated Contract Rates Is Not Dependent on Filing and an Opportunity for FERC Review

In *Mobile*, the Supreme Court recognized that the NGA "requir[es] contracts to be filed with the Commission."¹²⁸ Nonetheless, the First and D.C. Circuits have required the Commission to apply the *Mobile-Sierra* doctrine even where the contract had not been previously filed with FERC.¹²⁹ In our view, *Morgan Stanley* confirms that approach. As discussed, it squarely rejects the notion that *Mobile-Sierra* acts

¹²⁶ 16 U.S.C. § 824(a).

¹²⁷ FPC v. Sierra Pacific Power Co. 350 U.S. 348, 355 (1956).

¹²⁸ United Gas Pipe Line Co. v. Mobile Gas Servs. Corp., 350 U.S. 332, 338 (1956); see also Ark. La. Gas Co. v. Hall, 453 U.S. 571, 582 (1981) ("[T]he clear purpose of the congressional scheme" is to "gran[t] the Commission an opportunity in every case to judge the reasonableness of the rate."); 16 U.S.C. § 824d(c) (requiring that rates be filed).

¹²⁹ See Ne. Utils. Serv. Co., 993 F.2d at 960–62; Sam Rayburn Dam Elec. Coop. v. FPC, 515 F.2d 998, 1008 (D.C. Cir. 1975); Borough of Lansdale v. FPC, 494 F.2d 1104, 1113 (D.C. Cir. 1974).

“as the equivalent of an estoppel doctrine,’ whereby filing and an initial Commission opportunity for review prevents the Commission from modifying the rates absent serious future harm to the public interest.”¹³⁰ By concluding that the Commission must apply the *Mobile-Sierra* presumption to a contract regardless of “when [the] contract rate is challenged,”¹³¹ the Court eliminated any basis for suggesting that a party’s failure to satisfy the statutory filing requirement or FERC’s failure to provide itself an opportunity for initial review would permit the Commission to modify the contract under the lesser standard applicable to non-contract rates.

The requirement that rates be on file still serves an important role by putting third parties, including the Commission, on notice so they may, if necessary, challenge the contract rate under the public interest standard of *Mobile-Sierra*.¹³² And *Morgan Stanley* does not—by any stretch of the imagination—render the Commission powerless to enforce this or any other valid notice requirement, as a seller that fails to make a requisite filing may be subject to enforcement action or substantial penalties under the FPA.¹³³

Reading the filing requirement under the FPA as a notice requirement rather than a substantive prerequisite to making a contract rate effective, however, does have significant implications for the treatment of contracts under FERC’s market-based rate regime,

¹³⁰ *Morgan Stanley*, 128 S. Ct. at 2746 (quoting David G. Tewksbury & Stephanie S. Lim, *Applying the Mobile-Sierra Doctrine to Market-Based Rate Contracts*, 26 *Energy L.J.* 437, 457–458 (2005)).

¹³¹ *Id.* at 2745 (emphasis in original).

¹³² While *Mobile* pointed to the filing requirement imposed under the FPA (350 U.S. at 338), it did not suggest that some different standard would be applicable to contracts that were being filed with and reviewed by FERC for the first time. Instead, *Mobile* also appeared to view the filing requirement as simply providing an opportunity for Commission action. See *id.* at 339 (The act “permits the relations between the parties to be established initially by contract, the protection of the public interest being afforded by supervision of the individual contracts, which to that end must be filed with the Commission and made public.”).

¹³³ See 16 U.S.C. § 825h (granting the Commission the authority “to perform any and all acts . . . as it may find necessary or appropriate to carry out the provisions of this Act’); 16 U.S.C. § 825o (providing for fines of up to \$1,000,000 or five years imprisonment, or both, for a violation of the FPA, and for fines of up to \$25,000 for each day for violating a Commission rule); 16 U.S.C. § 825o-1 (providing for a civil penalty of up to \$1,000,000 per day for a violation of Part II of the FPA or any rule or order thereunder).

despite the Court's disclaimer in *Morgan Stanley* that it was not directly considering "the lawfulness of FERC's market-based-rates scheme."¹³⁴ It is well established that the Commission cannot completely delegate to the market's invisible hand its responsibility to ensure that prices are just and reasonable.¹³⁵ The Commission believes its market-based scheme satisfies that responsibility because the commission only authorizes sellers to charge market-based rates if they can demonstrate that they lack market power and continue to abide by reporting requirements.¹³⁶ We agree. But the respect accorded market-based rate contracts should not depend on whether that view is vindicated.

Although the Court recognized in *Morgan Stanley* that the market-based regime implemented by FERC "has its critics[,]"¹³⁷ the Court held unequivocally that *Mobile-Sierra* requires FERC to presume that all contracts are just and reasonable, and it made clear that "any needed revision in [FERC's market-based scheme] is properly addressed in a challenge to the scheme itself, not through a disfigurement of the venerable *Mobile-Sierra* doctrine."¹³⁸ This strongly suggests that, regardless of the lawfulness of FERC's market-based regime generally or of any party's compliance with that regime's requirements, its contract rate would be presumed just and reasonable and could only be undone if it were found to be contrary to the public interest. Of course, any seller that enters into a market-based contract without obtaining market-based rate authorization

¹³⁴ *Morgan Stanley*, 128 S. Ct. at 2747.

¹³⁵ See *FPC v. Texaco Inc.*, 417 U.S. 380, 397–98 (1974). The Ninth Circuit has held, based on *Texaco*, that FERC's market-based regime is lawful only if, through its reporting requirements, FERC continues to exercise oversight over sellers with market-based rate authority. See *Cal., ex rel. Lockyer v. FERC*, 383 F.3d 1006 (9th Cir. 2004).

¹³⁶ See *State of Cal., ex rel. Lockyer v. British Columbia Power Exchange Corp.*, 99 F.E.R.C. ¶ 61,247, at 62,061–65 (2002); see also generally Michael J. Gergen et al., *Market-Based Ratemaking and the Western Energy Crisis of 2000 and 2001*, 24 *Energy L. J.* 321 (2003).

¹³⁷ *Morgan Stanley*, 128 S. Ct. at 2747.

¹³⁸ *Id.* At the same time, the Court acknowledged that both the D.C. Circuit and the Ninth Circuit have generally approved FERC's market-based scheme and recognized "that when a seller files a market-based tariff, purchasers no longer have the option of buying electricity at a rate set by tariff and contracts no longer need to be filed with FERC (and subjected to its investigatory power) before going into effect." *Id.* at 2741–42.

or adhering to FERC's reporting requirements could be deemed to be in violation of the Commission's rules, and therefore be subject to enforcement action or penalties.¹³⁹ Under *Morgan Stanley*, however, this possibility would not appear to impact the enforceability of the contract rate itself. That is in our view also the correct policy result, because it permits market reliance on valid contracts while not excusing parties from filing obligations or depriving third parties and the Commission of the chance to assess the effect of contracts on the public interest.

VII. Conclusion

In holding that FERC must presume contracts to be just and reasonable, the Supreme Court reaffirmed the contemplated role of private contracts in the electric and natural gas industries and the long-term benefits conferred by contracts in terms of stability and investments. Under *Morgan Stanley*, a deal is a deal, absent extraordinary and demonstrable harm to the public interest.

¹³⁹ See *supra* note 133.

