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Supreme Court Ruling Provides Power Contract Protection

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On June 26, 2008, in *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1 of Snohomish County et al.* ("***Morgan Stanley v. Snohomish***"), the Supreme Court clarified the standard of review that the Federal Energy Regulatory Commission ("**FERC**" or "**Commission**") should apply to bilateral wholesale electricity contracts. In a 5-2 decision delivered by Justice Scalia, the Court affirmed that under the *Mobile-Sierra* doctrine, FERC "must presume that the rate set out in a freely negotiated wholesale energy contract meets the 'just and reasonable' requirement of the Federal Power Act," and that only upon concluding that the contract seriously harms the public interest may FERC modify the contract rate. In endorsing the *Sierra-Mobile* doctrine and the sanctity of contracts entered into pursuant to market-based rate authority, *Morgan Stanley v. Snohomish* clarifies that FERC must apply the same standard whether a contract challenge is brought by the seller or the buyer, and that the *Mobile-Sierra* doctrine binds FERC, not just the contracting parties.

The following provides a brief summary of the FERC and Ninth Circuit decisions underlying *Morgan Stanley v. Snohomish*, and a summary of the Supreme Court's holdings. The Court's opinion has important implications that parties should consider when entering into contracts subject to FERC's jurisdiction. While it is clear that freely negotiated bilateral contracts entered into by parties with market-based rate authority will enjoy significant protection under the Court's ruling, it is less clear what circumstances FERC may now consider sufficiently harmful to the public interest to warrant abrogation of a contract or changes in the applicable rate.

Background

Morgan Stanley v. Snohomish arose from attempts by Snohomish and other power-purchasing utilities to abrogate power contracts they entered into during the California energy crisis of 2000-2001. The purchasing utilities petitioned FERC to modify their contracts pursuant to its authority under the Federal Power Act ("**FPA**"). Under the FPA, FERC must find that wholesale energy rates are "just and reasonable." FERC denied purchasers' challenge to the contracts, holding that the *Mobile-Sierra* presumption – *i.e.*, that the rate agreed to in a freely negotiated wholesale energy contract meets the just and reasonable requirement of the FPA – applied and that the purchasers did not make the requisite showing of harm to the public interest to overcome the presumption. On rehearing, FERC affirmed this holding and noted that, while a showing of fraud, duress or bad faith between the parties at the contract formation stage could be an alternative ground for modifying the contracts, purchasers failed to make such a showing.

On appeal, the United States Court of Appeals for the Ninth Circuit reversed FERC's decision and remanded the case to FERC. The Ninth Circuit held (1) that the *Mobile-Sierra* presumption only applies where FERC has had an initial opportunity to review the contracts; and (2) that, even if the *Mobile-Sierra* presumption applied to the contracts at issue, a purchaser need show only that a contract price exceeds a "zone of reasonableness" (in this instance, marginal cost) to prove that the contract violates the public interest. The Ninth Circuit remanded the case to FERC to review in light of its holdings, but the Supreme Court granted certiorari.

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The Supreme Court disagreed with the Ninth Circuit's reasoning, but affirmed the Ninth Circuit's decision to remand on alternative grounds.

The Court rejected the Ninth Circuit's position that the *Mobile-Sierra* presumption only applies where FERC has had an initial opportunity to review the contracts. Rather, the Court held, the *Mobile-Sierra* presumption applies to bilateral wholesale power contracts regardless of when they are reviewed. However, the Supreme Court held that FERC may nonetheless determine that the *Mobile-Sierra* presumption does not properly apply to a contract in light of unfair dealing at the time of contract formation, explaining that "FERC has ample authority to set aside a contract where there is unfair dealing at the contract formation stage—for instance, if it finds traditional grounds for abrogation of the contract such as fraud or duress."

The Supreme Court also rejected the Ninth Circuit's holding that buyers challenging a high rate must show only that the rate is above the "zone of reasonableness" in order to overcome *Mobile-Sierra*; rather, the Court explained, "[t]he standard for a buyer's challenge must be the same, generally speaking, as the standard for a seller's challenge: The contract rate must seriously harm the public interest." As the Court stated, "We think that the FPA intended to reserve the Commission's contract-abrogation power for those extraordinary circumstances where the public will be severely harmed."

Despite its disagreements with the Ninth Circuit's reasoning, the Supreme Court remanded the case to FERC on alternative grounds, due to errors in FERC's analysis of the case at the outset. The Supreme Court directed FERC to clarify two points on remand. First, the Court directed FERC to clarify whether the contracts at issue imposed an excessive burden "down the line," relative to the rates consumers could have obtained (but for the contracts) after elimination of the dysfunctional market. In other words, FERC must analyze both the current and long-term, ongoing burden on consumers imposed by the contracts, and not just the burden imposed at the very outset of the contracts. "If the increase is so great that, even taking into account the desirability of fostering market-stabilizing long-term contracts, the rates impose an excessive burden on consumers or otherwise seriously harm the public interest, the rates must be disallowed."

Second, having held that FERC should not apply the *Mobile-Sierra* presumption if it determines that contract negotiations were directly affected by improper conduct at the contract formation stage (such as fraud, duress or unlawful market activity), the Court directed FERC on remand to clarify "whether it found the evidence [of market manipulation] inadequate to support the claim that [sellers'] alleged unlawful activities affected the contracts at issue here." In other words, FERC must consider whether there is a causal connection between unlawful market activity and the contract rates.

The Implications

Morgan Stanley v. Snohomish grants significant protection to bilateral contracts entered into by parties with market-based rate authority. This case makes clear that FERC may abrogate such a contract rate <u>only</u> if it seriously harms the public interest. Although the Court characterizes this "public interest standard" as merely a "differing *application* of the just-and-reasonable standard to market-based contract rates," the practical reality

is that FERC-jurisdictional rates that are set by bilateral contract (by parties with market-based rate authority) will enjoy more protection than rates established under cost-of-service tariffs. FERC must apply the *Mobile-Sierra* presumption to the former and the just and reasonable standard to the latter.

Because application of *Mobile-Sierra* is the default standard for bilateral contracts, contracting parties need not specify this standard in their contracts in order for FERC to apply the presumption on review. Of course, parties that wish to retain more regulatory oversight can contract out of the *Mobile-Sierra* presumption by so specifying with a *Memphis* clause. In addition, the Court has affirmed that before applying the *Mobile-Sierra* standard, FERC must determine whether there is unfair dealing at the contract formation stage.

It remains to be seen what circumstances FERC will consider, and the courts will endorse, as constituting a serious harm to the public interest, especially in the later stages of a contract's term. Where a rate might impair the financial ability of the public utility to continue its service, cast upon consumers an excessive burden, or be unduly discriminatory, the Supreme Court has agreed that such circumstances, though "not the exclusive components of the public interest" standard, would warrant abrogation of a contract. The factual circumstances that amount to an "excessive burden" or events that create "unequivocal public necessity" have yet to be clearly defined. In *Morgan Stanley v. Snohomish*, the Court indicates that a contract rate that is above marginal cost or creates "a small dent in the consumer's pocket" is not sufficiently harmful to overcome the *Mobile-Sierra* presumption. In the future, such as when FERC considers on remand whether the contract rates at issue impose an "excessive burden" on consumers, the industry may have some clarity as to those circumstances that are extraordinary enough to overcome the *Mobile-Sierra* presumption, and the factors that FERC may consider in order to make such a determination.

We will monitor the FERC remand proceeding. Market participants should consider filing comments depending upon how the FERC structures this further proceeding.

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