

# THE *MOBILE-SIERRA* RULE: ITS ILLUSTRIOUS PAST AND UNCERTAIN FUTURE

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In 1956, in the heyday of conventional cost-of-service regulation of the electric power and natural gas industries, the Supreme Court fashioned the *Mobile-Sierra* rule.<sup>1</sup> In language befitting a latter day power marketer, the Court counseled the Federal Power Commission (FPC) that Congress did not repeal the law of private contracts in enacting the Federal Power Act (FPA) and the Natural Gas Act (NGA). In the following forty-five years, the courts, the FPC, its successor, the Federal Energy Regulatory Commission (FERC or Commission), and the private litigants have struggled with this “refreshingly simple”<sup>2</sup> rule, which has been characterized as erecting “practically insurmountable”<sup>3</sup> barriers to contract reformation except on public interest grounds.

This article examines the origin of the rule, its application and evolution over time, and its current significance in the age of deregulation. Although several natural gas topics are discussed, the *Mobile-Sierra* rule is chiefly considered in an electric power context.

## I. THE ORIGIN

The *Mobile* case involved an effort by United Gas Pipe Line Company (United) to override its contractual obligations by charging its distributor customer, Mobile Gas Service Corporation (Mobile), a higher rate than allowed by their contract. The case arose out of a commercial opportunity in which a large industrial company had agreed to locate in Mobile's service area if Mobile would charge it a low rate. Motivated to attract the business, Mobile entered into two complementary contracts: a ten-year contract to supply gas to the industrial customer at 12¢ per million cubic feet (mcf) and a contract of like length with United to acquire gas to serve that customer at 10.7¢ per mcf. Thereafter, according to the Court opin-

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1. United Gas Pipe Line Co. v. Mobile Gas Serv. Corp., 350 U.S. 332 (1956); FPC v. Sierra Pacific Power Co., 350 U.S. 348 (1956).

2. Richmond Power & Light of City of Richmond, Ind. v. FPC, 481 F.2d 490, 493 (D.C. Cir. 1973) [hereinafter Richmond Power & Light], cert. denied, 414 U.S. 1068 (1973).

3. Papago Tribal Util. Auth. v. FERC, 723 F.2d 950, 954 (D.C. Cir. 1983) [hereinafter Papago II], cert. denied, 467 U.S. 1241 (1984).

ion, United repudiated its commitment to Mobile by increasing the price for this service to 14.5¢ per mcf. The FPC accepted United's filing of the higher rate and allowed it to use the rate to bill Mobile. Thus, contrary to its contractual expectations, Mobile found itself in the unenviable position of purchasing gas for 14.5¢ per mcf and reselling it to its customer for 12¢ per mcf.

Mobile found a sympathetic ear in the Third Circuit which held that United had violated its contract, and that the FPC should have rejected United's rate filing.<sup>4</sup> The Court required United to refund the difference between the 14.5¢ rate United had charged and the 10.7¢ rate United had promised to charge. In affirming the Third Circuit's reversal of the FPC, the Supreme Court in *Mobile* expounded on the FPC's rate authority and the limitations which circumscribe that authority in dealing with private contracts.

*Mobile's* fundamental ruling was that the NGA "evinces no purpose to abrogate private rate contracts as such."<sup>5</sup> The Court distinguished the natural gas industry under the NGA from the rail transportation industry under the Interstate Commerce Act, which then required price uniformity that precluded private rate arrangements. The Court described the NGA's rate-filing requirement as "expressly recogniz[ing] that rates to particular customers may be set by individual contracts."<sup>6</sup> Indeed, the Court observed that such individualized arrangements were a necessity in the natural gas industry<sup>7</sup> and that "[b]y preserving the integrity of contracts, [the NGA] permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry."<sup>8</sup> In effect, some forty years before the advent of market-based rates, the Court held that private parties operating in the wholesale gas supply market should be afforded the opportunity to make their own contracts with minimal supervision by the FPC.

Essential to the *Mobile* holding was the Court's rejection of an argument that section 4 of the NGA concerning the filing of new rates, and section 5 concerning the treatment of existing rates, created alternative rate-making procedures. According to that rejected argument, the sole section 4 issue upon the filing of a new rate was the new rate's reasonableness, with the contractual status of the existing rate demoted to an irrelevancy. Characterizing that argument as "based on a misconception of the structure of the Act,"<sup>9</sup> the Court ruled that the FPC's authority under sections 4 and 5 were the same, except that under section 4 the FPC could suspend a rate and allow it to be charged subject to refund. The Court also held that both the new rates under section 4 and the existing rates under section

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4. *Mobile Gas Serv. Corp. v. FPC*, 215 F.2d 883, 892 (3d Cir. 1954).

5. *United Gas*, 350 U.S. at 338.

6. *Id.*

7. *United Gas Pipe Line v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 338-39 (1956).

8. *Id.* at 344.

9. *United Gas*, 350 U.S. at 341.

5 were initially established by the utility and were subject to revision by the Commission only "upon a finding that they are unlawful."<sup>10</sup> In the case of section 4, a utility was free to file a new rate but only if it was contractually authorized to do so. *Mobile* also held that the avenue for relief for a gas company with a restrictive, uncompensatory contract was to submit information to the Commission showing that its rate was "so low as to conflict with the public interest,"<sup>11</sup> in which case the Commission under section 5(a) could authorize the increased rate that would take effect from and after the date of the Commission's determination that the contractual rate was unlawful.

As explained in *Sierra*, the companion case to *Mobile*, satisfying the public interest test would be no small accomplishment. *Sierra* also arose out of a commercial opportunity. The Court's opinion recounts that the selling utility, Pacific Gas & Electric Company (PG&E), had entered into a fifteen-year contract to sell power at a discounted rate to its customer Sierra Pacific Power Company (Sierra) when Sierra had an attractively priced alternative power supply. After five years Sierra lost that alternative, and while the contract was still in effect, PG&E exploited Sierra's lack of power supply alternatives by filing to increase Sierra's rate by approximately twenty-eight percent.<sup>12</sup>

Based on the same argument urged in *Mobile*,<sup>13</sup> the FPC allowed the increased rate to become effective subject to suspension and refund while it held a hearing to determine the rate's reasonableness. After the hearing, the FPC found not only that the new rate was reasonable, but also that the contractually established rate was unreasonable and therefore should be increased.

As in *Mobile*, the Court rejected the FPC's rationale that section 205 of the FPA justified its acceptance of PG&E's new rate filing without reference to PG&E's pre-existing contractual obligation. The Court found that the FPC lacked authority to accept PG&E's increased rate prior to its finding that the pre-existing contractually established rate was contrary to the public interest.

Confronting an issue not directly addressed in *Mobile*, *Sierra* determined that the FPC had applied the wrong public interest standard in determining that the contract rate "was unreasonably low and therefore unlawful."<sup>14</sup> While a non-contract rate could be unreasonable and therefore unlawful merely because it was too low, "it does not follow that the

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10. *Id.*

11. *United Gas*, 350 U.S. at 345.

12. *FPC v. Sierra Pacific Power Co.*, 350 U.S. 332, 352 (1956). In fairness to PG&E, it should be observed that although the increase in the rate would be 28%, the realized common equity return would increase from 2.6% to 4.75%, which even in the 1950s was hardly an exorbitant level. *Id.* at 353-54.

13. *Mobile Gas Serv. Corp. v. FPC*, 215 F.2d 883 (3d Cir. 1954) (the FPA rate change authority differed depending on whether a newly-filed rate under section 205 or an existing rate under section 206 was being considered).

14. *Sierra*, 350 U.S. at 354.

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."<sup>15</sup> Given the FPA's public interest purposes, the Court concluded that "a contract may not be said to be either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility."<sup>16</sup> In those circumstances in which a utility had contractually assumed the burden of a low rate, it could be increased only if it was "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."<sup>17</sup> Thus, the three-pronged, *Mobile-Sierra* test was born. For many years it could be said that it would be easier for a camel to pass through the eye of a needle than for a utility to increase a rate protected by the *Mobile-Sierra* rule.

Of the two decisions, *Mobile* appears the more substantive given its extensive analysis of NGA ratemaking authority and the interplay between that authority and contract law. In comparison, *Sierra* on first impression is a tag-along decision merely applying the substantive principles announced in *Mobile*. However, in certain respects *Sierra* is considerably more radical than its counterpart decision. Construed narrowly, *Mobile* merely recognizes that a utility can circumscribe its own right to file rate increases by entering into contracts restricting that right. While *Mobile* focuses on a utility's right to file new rates, *Sierra* takes the additional step of imposing a restriction on the Commission's authority over existing rates. Where *Mobile* merely says that existing rates may be modified if they are unjust and unreasonable, *Sierra* steps forward and defines what is just and reasonable in circumstances in which the parties have bound themselves by contract.

At least superficially, *Sierra* appears to represent a significant departure from the text of the statute. Section 206 of the FPA and the equivalent section 5 of the NGA do not explicitly incorporate separate standards of reasonableness for contract and non-contract rates. Moreover, both do direct the Commission to correct rates "whenever" they find them to be "unjust, unreasonable, unduly discriminatory, or preferential."<sup>18</sup> On its face, the "whenever" mandate applies across the board to all rates, be they embedded in contracts or otherwise. In establishing that contract rates were subject to the new standard of reasonableness, *Sierra* could cite only the 1923 precedent of *Arkansas Natural Gas Co. v. Arkansas Railroad Comm'n*,<sup>19</sup> which upheld a state statute regulating the price of natural gas but refused to abrogate bilateral gas supply contracts. *Arkansas* distinguished between setting rates and abrogating contracts, ruling: "It is the intervention of the public interest which justifies, and at the same time,

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15. *Id.* at 355.

16. *Sierra*, 350 U.S. at 355.

17. *Id.* at 355.

18. *FPC v. Sierra Pacific Power Co.*, 350 U.S. 332, 352 (1956).

19. *Arkansas Natural Gas Co. v. Arkansas R.R. Comm'n.*, 261 U.S. 379 (1923).

conditions its [contract abrogation] exercise."<sup>20</sup> *Arkansas* was a slim read to support the *Sierra* decision, since the charging of just and reasonable rates is also in the public interest.

Interpreting *Sierra* as holding that section 206 encompasses two standards of statutory reasonableness, one for non-contract rates and one for contract rates, is not the only alternative. Being more consistent with the statute, and less consistent with the language of the opinion, *Sierra* may be interpreted as recognizing that the existence of a contract has a dispositive effect on the public interest analysis used to determine justness and reasonableness. Under this interpretation of *Sierra*, the calculus for determining statutory justness and reasonableness is so heavily weighted by the existence of a contract that the contract may be found to be unlawful and may be modified only if the effects of the contract reach beyond the contracting parties and cause damage to the public interest. However, under either of the interpretations, *Sierra* recognized that the very same rate may be just, reasonable, and lawful when embodied in a contract and unjust, unreasonable, and unlawful in the absence of a contract. Thus, the *Mobile-Sierra* doctrine does not protect unlawful rates from unilateral revision by a party or the Commission. It does recognize that the existence of a contract infuses the rate with the attribute of reasonableness by virtue of the public interest provisions of the FPA and the NGA, which encompass the stability and adequacy of the energy supply as objectives, overriding public interest importance. Thus, the *Mobile* 10.7¢ rate was not an unreasonable rate protected by a contract, but a rate that was reasonable by virtue of the contract.

*Sierra* also recognized the rights of private parties to create barriers to seal themselves off from close Commission review of their contracts except in those circumstances where the public interest is significantly affected. In effect, the *Mobile-Sierra* doctrine created a sphere of quasi-deregulation years before the Commission adopted the concept of market-based rate-making.

Of course, without the *Sierra* requirement of public interest findings, the same just and reasonable standard would apply to both contract rate revisions and non-contract rate revisions. Under that condition, the only difference in treatment of a contract rate and non-contract rate would be the ability of the utility to make the non-contract rate effective immediately, subject to the Commission's suspension and refund authority. In other respects, without the public interest rulings required by the *Sierra* decision, the Commission would be able to overturn contract rates as readily as non-contract rates.

*Mobile* and *Sierra* advance no prophetic visions of the future in which lightly regulated market-based rates would be substituted for heavily regulated cost-based rates. The two cases were decided in the context of the FPC's close supervision of the two industries, and the contracts at issue in those cases appear to be conventional, long-term requirements contracts.

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20. *Id.* at 383.

However, even in that context, both decisions recognize that the FPA and the NGA provide that conventional regulation must give way to contracts that are the product of negotiation and market forces. Conventional regulation is allowed to encroach on this private domain "only in circumstances of unequivocal public necessity."<sup>21</sup>

## II. THE MIDDLE AGE OF THE *MOBILE-SIERRA* DOCTRINE

After the *Mobile-Sierra* doctrine was formulated, the Commission and the United States Courts of Appeals began the process of interpretation and implementation. *Richmond* and *Papago I* are decisions reflecting strict enforcement of the *Mobile-Sierra* doctrine<sup>22</sup> and judicial impatience with an agency that was seemingly loath to apply the doctrine zealously. By contrast, *Papago II* and *Kansas Cities*<sup>23</sup> are milestone decisions in the *Mobile-Sierra* analysis, representing a pendulum shift toward greater judicial deference to the Commission's view of whether or not the stringent *Sierra* public interest standard should be applied in particular instances.

*Richmond* characterized the *Mobile-Sierra* rule as "refreshingly simple."<sup>24</sup> According to the D.C. Circuit's oft-repeated characterization, "[t]he contract between the parties governs the legality of the filing. Rate filings consistent with contractual obligations are valid; rate filings inconsistent with contractual obligations are invalid."<sup>25</sup> However, *Richmond* and numerous other cases establish that, on occasion, the interpretation and application of this "refreshingly simple" rule has been frustratingly complex.

*Richmond* rebuffed the Commission's efforts to hold contracts on file with state regulatory agencies, which tied the utility's wholesale rate to the utility's retail industrial rate, were not subject to the *Mobile-Sierra* rule. The D.C. Circuit rejected the Commission's claim that the contractual reference to the state regulatory agency was ancillary to the contract's main intent and would be satisfied if the contract rate were filed with the Commission in accordance with FPA rate-changing procedures.<sup>26</sup> In pointed disagreement with the Commission, the D.C. Circuit found that the parties had negotiated a rate that tied the wholesale rate to the utility's retail rate in order to permit the customer to compete with the utility for industrial loads.<sup>27</sup> The court also rejected the Commission's finding that the contract was not a "fixed-rate" contract within the meaning of the *Mobile-Sierra* rule, because the contract contemplated that the rate could be changed as the utility's retail industrial rate changed.<sup>28</sup> The court held

21. *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968).

22. *Richmond Power & Light v. FPC*, 481 F.2d 490 (D.C. Cir. 1973); *Papago Tribal Util. Auth. v. FERC*, 610 F.2d 914 (D.C. Cir. 1979) [hereinafter *Papago I*], *cert. denied*, 467 U.S. 1241 (1984).

23. *Papago II*, 723 F.2d 950 (D.C. Cir. 1983); *Kansas Cities v. FERC*, 723 F.2d 82 (D.C. Cir. 1983).

24. *Richmond*, 481 F.2d at 493.

25. *Id.*

26. *Richmond*, 481 F.2d at 495.

27. *Id.* at 496.

the utility's retail industrial rate changed.<sup>28</sup> The court held that parties are free to negotiate not only fixed rates but also rates subject to change in a particular manner, and that "[i]n either case the contract is binding, and a unilateral filing is ineffective to change it."<sup>29</sup>

The court also perceived an FPC antipathy for the *Mobile-Sierra* rule as if the FPC viewed the rule as an irksome handcuff on its ability to fully exercise its FPA and NGA authority. The court described as "most troubling" the contention that use of the state rate as the benchmark for the FPA rate was an incursion on the Commission's jurisdiction. The court stated that "it shows that the Commission simply does not understand, or more likely is not willing to abide" by *Mobile-Sierra* principles.<sup>30</sup> Citing the *Mobile* decision, the court admonished that the Commission's concern over a loss of jurisdiction was unfounded because "denying . . . natural gas companies the power unilaterally to change their contracts in no way impairs the regulatory powers of the Commission, for the contracts remain fully subject to the paramount power of the Commission to modify them when necessary in the public interest."<sup>31</sup> Similarly, *Richmond* held that a second contract also tied the wholesale rate to the utility's retail industrial rate and was also entitled to *Mobile-Sierra* protection.

*Papago I* introduced another wrinkle. Whereas *Richmond* determined that parties could negotiate contracts that would tie wholesale rate changes to retail rate changes, *Papago I* recognized parties could also agree by contract to an FPA rate change mechanism that would prohibit the utility from filing rate increases under section 205, but would allow it to seek rate increases under section 206.<sup>32</sup> One practical significance of relinquishing the section 205 right and simultaneously retaining the section 206 right was that the utility could not place an increased rate into effect on a subject-to-refund basis, but could charge a higher rate only after the Commission had finally adjudicated the rate's reasonableness. Since Commission rate adjudications often require years to complete, *Papago I* preserved a drastic contract limitation on the Commission's ability in periods of rapidly rising costs to allow utilities to charge rates which it viewed as compensatory. However, *Papago I* did not decide whether a utility-initiated section 206 rate increase request would be governed by the just and reasonable standard or the *Sierra* public interest standard.

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28. *Richmond Power & Light v. FPC*, 481 F.2d 490, 496 (D.C. Cir. 1973).

29. *Id.* at 497.

30. *Richmond*, 481 F.2d at 497. *See also* *Borough of Lansdale v. FPC*, 494 F.2d 1104, 1110 (D.C. Cir. 1974) citing *Richmond Power & Light v. FPC*, 481 F.2d 490 (D.C. Cir. 1973) (Observing that "[t]he FPC very much dislikes the *Sierra-Mobile* doctrine.") citing *Lansdale, Sam Rayburn Dam Elec. Coop. v. FPC*, 515 F.2d 998, 1005 (D.C. Cir. 1975), *cert. denied*, 426 U.S. 907 (1976) (described "[t]he FPC's distaste for the *Mobile-Sierra* doctrine" as "well known" and described the Commission in the case before it as having "attempted what may charitably be termed as an 'end run'" by interpreting an "unmistakably" fixed rate contract to be a non-fixed rate contract).

31. *Richmond*, 481 F.2d at 497; *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 344 (1956).

32. *Papago I*, 610 F.2d 914, 928 (D.C. Cir. 1979).

The latter determination was made by *Papago II*. It found that the parties' contract permitted section 206 changes based on the just and reasonable standard rather than the public interest standard, and thereby emphasized another important dimension to the *Mobile-Sierra* analysis by recognizing that contracts relinquishing a utility's section 205 rights did not necessarily leave the utility to the mercies of the *Mobile-Sierra* public interest test.<sup>33</sup> In concluding that the contract permitted changes under the just and reasonable standard, the court relied on contractual language stipulating that the rate was to be in effect for an initial term of one year "and thereafter unless and until changed by the Federal Power Commission."<sup>34</sup> Observing that, in its first year, the contract was subject to the strict *Mobile-Sierra* public interest standard, the court reasoned that the term "thereafter" in the contract was "obviously intended to be less restrictive [and] must therefore permit changes that are just and reasonable."<sup>35</sup> In a telling comment, the court stated that contractual recognition of the possibility of future rate change would be "virtually meaningless," except under the just and reasonable standard because the public interest standard is "practically insurmountable."<sup>36</sup> Significantly, the stringency of the public interest standard was a factor influencing the *Papago II* determination that the parties intended (after one year) to apply the just and reasonable standard rather than the public interest standard.

*Kansas Cities* and *Papago II* were decided on the same day and both opinions were written by Judge Scalia.<sup>37</sup> Like *Papago II*, *Kansas Cities* added still another twist to the *Mobile-Sierra* doctrine by holding that contractual regulatory approval clauses (RAC or RACs), given certain language and certain circumstances, contemplated rate changes under the just and reasonable standard rather than the strict *Mobile-Sierra* public interest standard. The court evaluated RACs in two contracts (involving the Towns of Neodesha and Bronson). One RAC stated that the rate schedule was subject to change through orders of the state commission. The other stated that it was subject to change via valid regulatory orders, including rate orders.<sup>38</sup> Following *Papago II*, the court divided all contracts into three categories: those permitting unilateral rate changes by the utility under section 205;<sup>39</sup> those permitting changes under section 206 subject to the *Mobile-Sierra* public interest standard; and those permitting changes under

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33. See generally *Public Service Co. of New Mexico v. FERC*, 628 F.2d 1267, 1270 (10th Cir. 1980), cert. denied, 451 U.S. 907 (1981); *Louisiana Power & Light Co. v. FERC*, 587 F.2d 671, 676 (5th Cir. 1979).

34. *Papago II*, 723 F.2d 950, 953 (D.C. Cir. 1983).

35. *Id.* at 954.

36. *Papago II*, 723 F.2d 950, 954.

37. *Kansas Cities v. FERC*, 723 F.2d 82, 87 (D.C. Cir. 1983).

38. *Id.* at 86-87.

39. Contract clauses permitting unilateral changes are known as "Memphis" clauses, named after the Supreme Court's decision in *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division*, 358 U.S. 103 (1958), recognizing that certain contracts preserved a utility's right to make unilateral filings under NGA section 4 or, by inference, FPA section 205.



section 206 subject to the just and reasonable standard. Then the court candidly acknowledged that ascertaining the parties' intent as to whether these two contracts belonged in the second or third category was like looking "for a needle in a haystack in which there is good reason to believe no needle exist[ed],"<sup>40</sup> because when the contracts were executed, "it was not clearly understood that the third category existed," and it was believed that all such contracts fell into the second category.<sup>41</sup> Of course, the court might have drawn the opposite inference. It could have concluded that the existence of only the second *Mobile-Sierra* category at the time of contract formation logically led to the conclusion that the contracts were intended to be second category contracts. After all, if the parties at the contract formation stage were unaware of the existence of the third category, if their contracts post-dated the *Mobile-Sierra* decisions, and if the parties believed their choices were limited to the first or second category, it is unlikely they intended to adopt a third-category contract.

Nevertheless, the court concluded that the contracts fell into the third category. The court in part relied on the expertise of the Commission, which had found the contracts subject to change under section 206 of the FPA. As in *Papago II*, the stringency of the *Mobile-Sierra* public interest standard also influenced the court's decision to treat the contracts as subject to change based on just and reasonable criteria. The court adopted the inference that any contractual provision relating to a rate change referred to the just and reasonable standard because the public interest standard was "almost insurmountable," and thus a rate change mechanism governed by that standard would be "virtually inoperative."<sup>42</sup>

The RACs in the Neodesha and Bronson contracts incorporated specific references to rate changes and were susceptible to a determination that they contemplated rate change under a less stringent standard than the *Mobile-Sierra* standard. However, the RAC in the "Iola" contract merely provided that: "[The] contract and all obligations hereunder are conditioned upon the valid orders of, and the granting of approval and authorization by any Commission or other regulatory body having jurisdiction."<sup>43</sup> This was the type of RAC that other courts had previously found to not exclude *Mobile-Sierra* protection. Those decisions rested on the ground that the RACs referred to regulatory change in general rather than a rate change in particular.<sup>44</sup> Since contracts routinely contain RACs, including the contracts reviewed by the courts in the *Mobile* and *Sierra* decisions,<sup>45</sup> a finding that RACs eliminate the need to invoke the public interest standard would to a large extent nullify the *Mobile-Sierra* doctrine on

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40. *Kansas Cities*, 723 F.2d at 87.

41. *Id.*

42. *Kansas Cities*, 723 F.2d at 87-88.

43. *Id.* at 89.

44. *See, e.g., Gulf States Utilities Co. v. FPC*, 518 F.2d 450, 453-55 (D.C. Cir. 1975).

45. *Kansas Cities v. FERC*, 723 F.2d 82, 88 (D.C. Cir. 1983) (quoting the RACs reviewed in the *Mobile* and *Sierra* decisions).

an across-the-board basis.

The court nevertheless agreed with the FERC's analysis that the Iola RAC permitted just and reasonable changes to the contract's non-firm service provisions, although it did so in a manner that restricted the attenuating effect of its ruling on the *Mobile-Sierra* doctrine. The Iola contract provided for firm service and non-firm service, contained a plain *Mobile-Sierra* clause that applied to firm service only, and also contained a RAC that applied to both services. The court concluded those specific facts supported the inference that the parties intended more flexibility in changing non-firm rates than firm rates. Accordingly, the non-firm rates could be revised under the just and reasonable standard. The court stated that it would not "normally" view such a RAC as a rate change clause, since it dealt "with regulatory matters in general and not with ratemaking in particular."<sup>46</sup> However, it regarded the existence of the two clauses in the same contract as "[t]he interpretive factor of central importance."<sup>47</sup>

Characterizing judicial decisions as falling in one doctrinal category or another is always challenging. For example, the *Mobile*, *Sierra*, *Richmond*, and *Papago I* cases could be viewed as consumer-protection cases, in that each decision preserved a customer's lower contract rate in the face of the supplier's attempt to charge a higher rate. However, the chief concern of the *Mobile* and *Sierra* decisions was the preservation of the integrity of contracts and the limitations on the Congressional delegation of authority to the FPC to encroach on private contractual arrangements. Similarly, *Richmond* and *Papago I* were logical extensions of the *Mobile-Sierra* precepts to contracts containing provisions somewhat different than those reviewed in *Mobile* and *Sierra*. However, a common thread unifying all four decisions is that they impose limits on the Commission's authority and enable private parties to determine the terms on which NGA and FPA jurisdictional service would be provided. Of course, such limitations are a double-edged sword, since contracts can result in customers paying higher rates as well as lower rates.

*Papago II* and *Kansas Cities* resulted in customers paying higher rates rather than lower rates. In *Kansas Cities*, the court recognized that the *Mobile-Sierra* rule was rate neutral in that *Mobile-Sierra* protections lock-in not only low rates in times of high costs, but also high rates in times of low costs.<sup>48</sup> *Papago II* and *Kansas Cities* also give the regulator greater control over contracts. In fact, the principal difference between the *Richmond* and *Papago I* decisions and the *Papago II* and *Kansas Cities* decisions may be that *Kansas Cities* and *Papago II* reflect greater deference to the regulator. For example, contrast the *Richmond* decision (and the *Lansdale* and *Sam Rayburn* decisions) chastising the Commission for its failure to enthusiastically follow *Mobile-Sierra* tenets, with *Papago II* and *Kansas Cities*, which assert the need for deference to the Commission's ex-

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46. *Id.* at 90.

47. *Kansas Cities*, 723 F.2d at 90.

48. *Id.* at 88.

pertise and then perform extensive analyses in order to sustain the Commission's interpretations. In other words, all four decisions conscientiously attempt to apply the *Mobile-Sierra* rule, but *Kansas Cities* and *Papago II* emphasize the need for agency deference and for the agency to determine within reasonable bounds how best to implement the *Mobile-Sierra* mandate.

Attempting to characterize those decisions as progressive or regressive, depending on their capacity to accommodate to market-based rate concepts would also yield anomalous results. Arguably, *Richmond* and *Papago I* evince more compatibility with market-based rate concepts owing to the limits they impose on regulatory authority and their support of parties' rights to create their own contractual arrangements. By contrast, *Papago II* and *Kansas Cities* could be viewed as less compatible with market-based rates because, through their deference to the regulator, they narrow the *Mobile-Sierra* zone within which parties have the right to enter into contracts with a minimum of regulatory interference. Viewed from a different angle, the rationale underlying *Richmond* and *Papago I* might make it more difficult for a regulatory agency to overturn contracts that might stand as obstacles to industry restructuring; whereas the judicial deference embodied in *Papago II* and *Kansas Cities* affords the regulator a greater opportunity to eliminate contractual impediments to restructuring. Thus, *Papago II* and *Kansas Cities* have dual impacts: they narrow the relative freedom from regulation created by the *Mobile-Sierra* rule, while their emphasis on judicial deference would accord the Commission broad latitude to engage in industry restructuring initiatives. Of course, the concern of *Papago II* and *Kansas Cities* was not industry restructuring; rather, the underlying dynamic of both decisions appears to be that, within reasonable limits, the Commission and not the court should have primary responsibility for implementing the regulatory statutes under which the Commission operates. As part of that responsibility, the Commission would be granted discretion to determine, through contract interpretation, which contracts are subject to review under the *Mobile-Sierra* standard, and which contracts may be revised more easily under the just and reasonable standard.

### III. MOBILE-SIERRA PROTECTS HIGH RATES AS WELL AS LOW RATES

The *Mobile-Sierra* rule arose out of cases where it was invoked to protect customers from contractually unauthorized rate increases. However, the logic of the rule and the public interest considerations underlying its development, as articulated in *Mobile*, establish that the rule is rate-neutral. The doctrine protects contracts not rates; and it is as protective of contracts that contain high rates as it is of contracts that contain low rates. In a case involving the New York Public Service Commission, the D.C. Circuit held that a contract is binding except as "demanded" by "exigencies of the public interest," and that the *Mobile-Sierra* doctrine obligates both buyer and seller under a contract, and that the Commission was no more at liberty to alter a contract "to the prejudice of the producers than

to do so in their favor."<sup>49</sup> That ruling was consistent with a subsequent First Circuit ruling, relying on the filed rate doctrine as well as the law of contracts, that a claims limitation clause in a contract precludes the FERC from ordering refunds of excess revenues that were collected outside of a contractual claims limitation period.<sup>50</sup> The First Circuit in the *Northeast II* case applied the *Mobile-Sierra* doctrine, albeit a less stringent version than the classic virtually insurmountable test, to Commission-prescribed changes in the utility's proposed method for calculating its rates.<sup>51</sup> More recently, the D.C. Circuit affirmed a FERC ruling which, relying on the *Mobile-Sierra* rule, refused to reduce a utility's contractually established transmission rate to the level in the utility's open-access tariff.<sup>52</sup>

Those rulings accord with the principle, which does not distinguish between contract revisions beneficial either to utilities or to their customers, that "[t]he regulatory system created by the Act is premised on contractual agreements voluntarily devised" and "contemplates abrogation of [those] agreements only in circumstances of unequivocal public necessity."<sup>53</sup> Similarly, the above-quoted *Mobile* mandate that "[i]n construing the Act, we should bear in mind that it evinces no purpose to abrogate private rate contracts as such"<sup>54</sup> and does not distinguish between contracts with higher rates which customers are seeking to reduce and contracts with low rates which utilities are seeking to increase.

Those rulings also comport with the *Papago II* observation that "[t]he adoption of a strict or lenient standard for rate change, however, does not necessarily favor either [utility or customer] since its effect will depend upon whether upward or downward revision is sought."<sup>55</sup> *Mobile*, the well-spring case, lays down the precept that stability of contracts is essential to the health of the industry.<sup>56</sup> While the *Mobile* discussion was in the context of the gas pipeline company as the applicant for unilateral rate increase, the overriding objective of protecting contracts as a means of ensuring stability of supply and the health of the industry applies whether the assault on the contract is launched by the service provider or its customers.

The *Northeast I* and *II* decisions,<sup>57</sup> discussed in detail below, suggest that the kind of public interest analysis for determining whether a contract should be modified could partially depend in some circumstances on whether or not the contract was a low rate contract or a high rate contract. However, both *Northeast I* and *II* stand for the proposition that high rate

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49. *Public Serv. Comm'n of the State of New York v. FPC*, 543 F.2d 757 at 798 (D.C. Cir. 1974).

50. *Boston Edison Co. v. FERC*, 856 F.2d 361, 372 (1st Cir. 1988).

51. *Northeast Util. Serv. Co. v. FERC*, 993 F.2d 937 (1st Cir. 1993) [hereinafter *Northeast I*]; *Northeast Util. Serv. Co. v. FERC*, 55 F.3d 686 (1st Cir. 1995) [hereinafter *Northeast II*].

52. *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403 (D.C. Cir. 2000).

53. *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 882 (1968).

54. *United Gas Pipe Line Co. v. Mobile Gas Serv. Co.*, 350 U.S. 332, 338 (1956).

55. *Papago II*, 723 F.2d 950, 955 (1983) citing *Kansas Cities v. FERC*, 723 F.2d 82, 87 (D.C. Cir. 1983).

56. *Mobile*, 350 U.S. at 344.

57. *Northeast I*, 993 F.2d 937 (1st Cir. 1993); *Northeast II*, 55 F.3d 686 (1st Cir. 1995).

contracts, as well as low rate contracts, are both subject to the *Mobile-Sierra* doctrine.

#### IV. PUBLIC INTEREST MODIFICATION OF NATURAL GAS CONTRACTS

As noted above, the *Mobile-Sierra* public interest test has created a significant barrier to the Commission's reformation of bilateral contracts. However, the courts have permitted the Commission to modify contracts in the public interest as part of the implementation of broad-based policy initiatives. Since the 1960s, the Commission has pursued numerous such initiatives in which it amended or abrogated private contracts in the natural gas industry. Those actions were undertaken industry-wide after fact-finding involving issues of national concern. The Commission's Order No. 636, which required industry-wide unbundling of services rendered by natural gas pipelines, is the culminating example in a series of gas restructuring initiatives.<sup>58</sup> The courts upheld each of these major restructuring orders in substantial part as: (1) a legitimate exercise of the Commission's statutory authority, and (2) consistent with the *Mobile-Sierra* public interest standard. In other words, these broad-based initiatives were not viewed as exempt from the *Mobile-Sierra* public interest standard. Instead, they were viewed as satisfying that standard.

In the early 1960s, the Commission, pursuant to section 5 of the NGA, established an area-wide geographical system of setting rates for natural gas sold by producers.<sup>59</sup> In upholding the Commission's abrogation of thousands of individual contracts, the Supreme Court found that the Commission "has plenary authority to limit or to proscribe contractual arrangements that contravene the relevant public interests."<sup>60</sup> In 1971, in response to nationwide shortages of natural gas, the Commission required natural gas pipelines to submit curtailment plans that abrogated contractual duties to sell gas to certain customers.<sup>61</sup> Again, the Supreme Court affirmed the FERC's authority, when the public interest so required it, to alter private contracts in implementing broad national policy.<sup>62</sup>

In 1984, the FERC acted pursuant to section 5 to eliminate contractual arrangements that had required customers to pay for a minimum volume of gas whether or not the customer actually received the gas.<sup>63</sup> The

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58. Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [Regs. Preambles 1991-1996] III F.E.R.C. STATS. & REGS. ¶ 30,939 (1992), *order on reh'g*, Order No. 636-A, [Regs. Preambles 1991-1992] F.E.R.C. STATS. & REGS. ¶ 30,950 (1992), *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶ 61,272 (1992), *reh'g denied*, 62 F.E.R.C. ¶ 61,007 (1993).

59. *Statement of General Policy No. 61-1*, 24 F.P.C. 818 (1960). For example, the Permian Basin was defined to include parts of Texas and New Mexico. 24 F.P.C. 1121, 1122 (1960), *reh'g denied*, 25 FPC 249 (1961).

60. *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968).

61. Order No. 431, 45 F.P.C. 570 (1971).

62. *FPC v. Louisiana Power & Light Co.*, 406 U.S. 621, 646-47 (1972).

63. Order Nos. 380, *Elimination of Variable Costs From Certain Natural Gas Pipeline Minimum Commodity Bill Provisions*, [Regs. Preambles 1982-1985] F.E.R.C. STATS. & REGS. ¶ 30,571 (1984),

D.C. Circuit affirmed the Commission.<sup>64</sup> In 1985, after extensive notice and comment proceedings, the FERC required pipelines accepting blanket transportation authorizations to permit their customers to convert their bundled sales contracts to unbundled, transportation-only contracts.<sup>65</sup> The Commission's section 5 orders were affirmed on appeal.<sup>66</sup> As noted above, in 1992, the FERC exercised its section 5 authority to prohibit pipelines from offering bundled services, i.e., from selling gas and transportation as a bundled product. That prohibition was also affirmed on appeal.<sup>67</sup>

Thus, the Commission has abrogated or revised contracts in the natural gas industry on an industry-wide basis to implement generic federal policies. The courts have had no difficulty finding that the Commission has "public interest" authority under *Mobile-Sierra* to implement those policies. The Commission was able to set aside contracts directly or indirectly at virtually every level of the natural gas industry. The Commission had jurisdiction over contracts between producers and pipelines, and in appropriate public interest circumstances, the authority to modify those contracts. Although contracts between interstate pipelines and their industrial direct purchasers were deemed to be subject to local, rather than FERC jurisdiction, the Commission did have statutory authority that extended to pipelines, transportation facilities, and operational activities. That authority provided the basis for the Commission to modify the contractual arrangements by which the pipelines sold gas to the industrial end-users. On the other hand, the Commission has never had any jurisdiction over contracts between gas distributors and their customers, nor has the commission ever taken any action that directly modified those contracts. However, the Commission was able indirectly to affect the parties' rights under such distributor contracts by determining the terms, conditions, and prices under which distributors could obtain gas from interstate pipelines and producers.

An obvious dissonance exists between agency regulatory authority and the contract rights of regulated entities, because the latter has the tendency to circumscribe and restrict the former. This dissonance is reflected

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Order No. 380-A, *Elimination of Variable Costs From Certain Natural Gas Pipeline Minimum Commodity Bill Provisions*, [Regs. Preambles 1982-1985] F.E.R.C. STATS. & REGS. ¶ 30,584 (1984), Order No. 380-C, *Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions*, [Regs. Preambles 1982-1985] F.E.R.C. STATS. & REGS. ¶ 30,607 (1984), *Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions*, 29 F.E.R.C. ¶ 61,332 (1984).

64. *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986).

65. Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [Regs. Preambles 1982-1985] F.E.R.C. STATS. & REGS. ¶ 30,665 (1985), Order No. 436-A, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [Regs. Preambles 1982-1985] F.E.R.C. STATS. & REGS. ¶ 30,675 (1985).

66. *Associated Gas Distrib. v. FERC*, 824 F.2d 981 (D.C. Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988).

67. *United Distrib. Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996), *cert. denied*, 520 U.S. 1224 (1997).

in the bilateral contract disputes discussed above. There the courts created a zone contractual activity that was largely exempt from Commission review. Absent overriding public interest impacts, this zone is subject to the control of private parties' contracts and is exempt from the Commission's revision power. The Commission has maximum authority to intrude on this private contractual sphere when it is acting on an industry-wide basis, in which case the Commission is not only able to modify such contracts, but to eradicate them to the extent they are obstacles to achieving its overall regulatory objectives. Whereas, in their inception *Mobile-Sierra* protections represented a form of modest deregulation, those contract protections were easily overcome to the extent they stood as potential barriers to the Commission's own efforts at industry restructuring and the substitution of competition for regulation.

#### V. THE *NORTHEAST* DECISIONS—A RELAXATION OF THE PUBLIC INTEREST CRITERIA FOR CONTRACT REFORMATION

In the *NGA* cases discussed above, the Commission believed and the courts agreed that the public interest, as manifested in the various programs the Commission was proposing, justified the contract reformations and repudiations it prescribed. More recently, a contract involving Northeast Utilities Service Company (Northeast) led to litigation which whittled away at the classic *Mobile-Sierra* doctrine. The FERC and the First Circuit viewed this dispute as having public interest implications although the dispute did not involve industry-wide arrangements.<sup>68</sup> Also, the Northeast cases differ from *Papago II* and *Kansas Cities*, which reacted to the stringency of the *Mobile-Sierra* public interest doctrine, by deferring to the Commission's determination that the doctrine did not apply in particular instances. Taking a different tack, the *Northeast* cases challenge the premise of *Papago II* and *Kansas Cities* that the public interest test is "practically insurmountable" in all instances, and they adopt an alternative version of the test that is less stringent than the three-pronged test formulated in *Sierra*. The importance of the *Northeast* cases is that they potentially presage an increase in the Commission's ability to modify contracts, even in circumstances where national policy is not an issue.

The Northeast contract explicitly incorporated the *Mobile-Sierra* public interest standard by providing that the Commission could not change the rate unless the Commission found that the rate was contrary to the public interest. Nevertheless, in its initial orders in that case, the FERC refused to apply the *Mobile-Sierra* public interest test, applying the more lenient just and reasonable standard in disapproving a provision for automatically adjusting common equity return and a provision for determining

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68. *Northeast Utils. Serv. Co.*, Initial Decision, 53 F.E.R.C. ¶ 63,020 (1990), *aff'd in part and denied in part*, Opinion No. 364, 56 F.E.R.C. ¶ 61,269 (1991), *on consideration* Opinion No. 364-A, 58 F.E.R.C. ¶ 61,070 (1992), *denying reh'g*, Opinion No. 364-B, 59 F.E.R.C. ¶ 61,042 (1992); *Northeast I*, 993 F.2d 937 (1st Cir. 1993); FERC's orders on remand, *Northeast Utils. Serv. Co.*, 66 F.E.R.C. ¶ 61,332 (1994), *order denying reh'g*, 68 F.E.R.C. ¶ 61,041 (1994); *aff'd* *Northeast II*, 55 F.3d 686 (1st Cir. 1995).

decommissioning expense.<sup>69</sup> In *Northeast I*, the First Circuit faulted the Commission for modifying the contract based on the just and reasonable standard rather than the *Mobile-Sierra* public interest standard.<sup>70</sup> The *Northeast I* decision described the FERC as impermissibly

conflat[ing] the 'just and reasonable' and 'public interest' standards, thereby circumventing the *Mobile-Sierra* doctrine. The distinction between the 'just and reasonable standard' and 'public interest' standards loses its meaning entirely if the Commission may modify a contract under the public interest standard where it finds the contract 'may be unjust [or] unreasonable.'<sup>71</sup>

In remanding the case, *Northeast I* directed the Commission to consider the rate under the public interest standard.<sup>72</sup> However, providing creative guidance to the Commission, the court hinted its views, which were later expressed in *Northeast II*,<sup>73</sup> by stating that safeguarding the interests of third parties constituted the "most attractive case" for modifying a contract while complying with the *Mobile-Sierra* public interest test.<sup>74</sup>

Following this *Northeast I* guidance, the FERC on remand proceeded to apply the *Mobile-Sierra* public interest standard, but it did so in a highly innovative way enabling it to reach the same result it had reached earlier under the just and reasonable standard. The Commission concluded the public interest standard must be applied flexibly and relied on the following grounds to modify the contract: the contract had not previously been filed with or accepted by the Commission; the contract was between affiliates and thus not the product of arms-length bargaining; and the parties to the contract could be adversely affected by the contract's provisions.<sup>75</sup>

In its order on remand adopting a more lenient public interest standard for modifying contracts, the Commission stated that: (1) the "public interest" standard of review under the *Mobile-Sierra* doctrine cannot be 'practically insurmountable' in all cases;<sup>76</sup> (2) in certain circumstances, application of a "more flexible" standard than the "practically insurmountable" *Mobile-Sierra* standard was appropriate;<sup>77</sup> (3) we do not believe that the public interest standard of review is "practically insurmountable" in all circumstances;<sup>78</sup> and (4) application of a "more flexible standard" in the circumstances of this case is appropriate.<sup>79</sup>

The Commission did not discard the notion of fidelity to contract obligations. Instead, it stated that in contract reformation cases it must undertake a thorough analysis of the relevant factors, prominent among them

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69. 53 F.E.R.C. ¶ 63,020, at 65,235-36; 56 F.E.R.C. ¶ 61,269, at 61,993.

70. *Northeast I*, 993 F.2d at 962.

71. *Id.* at 961.

72. *Northeast I*, 993 F.2d at 962.

73. *Northeast II*, 55 F.3d 686 (1st Cir. 1993).

74. *Northeast I*, 993 F.2d 937, 960-61 (1st Cir. 1993).

75. *Northeast Utils. Serv. Co.*, 66 F.E.R.C. ¶ 61,332 (1994).

76. 66 F.E.R.C. ¶ 61,332, at 62,076 (footnote omitted).

77. *Id.* at 62,076.

78. 66 F.E.R.C. ¶ 61,332, at 62,087 (footnote omitted).

79. *Id.*



the parties' expectations in entering the contract and the public interest and third party impacts, if any, associated with the proposed contract change. The Commission cited *Mobile* as recognizing that the goals of the FPA contain an inherent tension of "conflicting interests," that of protecting contract stability on the one hand, and effecting public regulation on the other.<sup>80</sup> The Commission then stated that in applying the *Mobile-Sierra* doctrine, it was obligated to "achieve a 'reasonable accommodation' between the conflicting goals of the FPA to respect private contractual arrangements while also protecting the interests of third parties through effective regulation."<sup>81</sup>

The Commission also said that protection of the public interest was achieved through its supervision of individual contracts and by its consideration of the "reciprocal expectations of the parties that each will continue to receive or pay, as the case may be, the rate for which it has bargained and that already has been accepted by the Commission."<sup>82</sup> The Commission characterized "protecting contract stability" and "respect [of] private contractual obligations" as threshold factors to be evaluated in the first instance in determining how to apply the public interest standard in contract modification cases.<sup>83</sup> The Commission emphasized that it was modifying the contract "under the public interest standard of review."<sup>84</sup> Then, in its rehearing order, the Commission drew a sharp line between the classic "practically insurmountable" *Mobile-Sierra* standard and the more flexible public interest standard which it was applying.<sup>85</sup>

In a sense, the Commission was retreading previously rejected arguments. Both *Mobile* and *Richmond*, had previously declined to accept arguments similar to the Commission's rationale in *Northeast*, that the Commission's exercise of supervisory authority over contracts in itself satisfied public interest considerations and obviated the need to defer to the parties' contracts.<sup>86</sup> Similarly, *Borough of Lansdale* had specifically rejected the Commission's ruling that the *Mobile-Sierra* doctrine "has no application to 'new' contracts not yet on file with the Commission."<sup>87</sup> However, the substantive difference between the Commission's rationale in *Northeast* and in *Mobile*, *Richmond*, and *Lansdale* is that in the latter three

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80. *Northeast Utils. Serv. Co.*, 66 F.E.R.C. ¶ 61,332, 62,082 (1994) (footnote omitted).

81. *Id.* at 62,087 (footnote omitted).

82. 66 F.E.R.C. ¶ 61,332, at 62,088.

83. *Id.* at 62,082; *See also supra* notes 38 and 39.

84. 66 F.E.R.C. ¶ 31,332, at 62,088.

85. *Northeast Utils. Serv. Co.*, 68 F.E.R.C. ¶ 61,041, 61,137 (1994).

86. *Compare Northeast Utils. Serv. Co.*, 66 F.E.R.C. ¶ 61,332, 62,088 (1994) with *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 344 (1956) and *Richmond Power and Light Co. v. FPC*, 481 F.2d 490, 497 (D.C. Cir. 1973).

87. *Borough of Lansdale v. FPC*, 494 F.2d 1104, 1112-14 (D.C. Cir. 1974). In support of its ruling, the court cited *Natural Gas Pipe Line Co. v. FPC*, 253 F.2d 3, 7 (3d Cir. 1958), *cert. denied*, 357 U.S. 927 (1958) as precedent and relied heavily on the Supreme Court's analysis in the *Mobile* and *Sierra* decisions to determine that contracts are subject to the *Mobile-Sierra* doctrine regardless of when they are executed and whether or not they have been filed with or accepted by the Commission. *See also Sam Rayburn Dam Elect. Coop. v. FPC*, 515 F.2d 998, 1008-09 (1975).

cases the Commission's contention was that the *Mobile-Sierra* doctrine did not apply. By contrast, in *Northeast* the Commission acknowledged the applicability of the *Mobile-Sierra* rule and its findings were advanced merely to support the use of a more lenient version of the *Mobile-Sierra* public interest test than the "practically insurmountable" three-pronged test announced in *Sierra*.

On appeal from the Commission's orders on remand, the First Circuit in *Northeast II* endorsed the Commission's definition of a broader public interest test than the "nearly insurmountable" *Mobile-Sierra* test. *Northeast II* characterized the *Sierra* decision, the origin of the three-pronged test, as a "low rate" case; i.e., one where the utility's purpose was to increase a customer's rate despite a contractual bar against rate increases. In that circumstance, the only affected parties are the utility seeking to charge the higher rate and the customer to whom the higher rate would be applied. No third parties are affected (except the customer's customers who would pay the cost of the rate increase). The court stated that the *Mobile-Sierra* "definition of what is necessary in the public interest," having been formulated in a "low-rate case, . . . was not and could not be an across-the-board definition of what constitutes the public interest in other types of cases."<sup>88</sup> The court also held that the public interest test as applicable in other types of cases (i.e., non-low rate cases) was not a "practically insurmountable" test. *Northeast II* characterized the *Papago II* reference to the "practical[ ] insurmountab[ility]" of the *Mobile-Sierra* public interest test as *dicta*. It commented "neither *Mobile* nor *Sierra* stated or intimated that the 'public interest' doctrine was 'practically insurmountable.'"<sup>89</sup>

Without attempting to define all cases in which a public interest standard other than the stringent *Mobile-Sierra* standard might apply, *Northeast II* reaffirmed the *Northeast I* view that "the most attractive case for affording additional protection [under the public interest standard], despite the presence of a contract, is where the protection is intended to safeguard the interests of third parties."<sup>90</sup> *Northeast II* then affirmed the Commission's modification of the contract under a relaxed public interest standard chiefly because of the impact on third parties.<sup>91</sup>

In its *Northeast* order, the FERC had also asserted that a more flexible public interest standard should apply when it initiates the investigation *sua sponte* or at the request of a non-party rather than at the request of a party to the contract.<sup>92</sup> While *Northeast II* determined that protection of non-party interests could be a basis for applying a more flexible public interest standard, *Northeast II* did not find that the mere method of initiating an investigation should influence the final decision as to whether a contract

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88. *Northeast II*, 55 F.3d 686, 690 (1st Cir. 1995).

89. *Id.* at 691.

90. *Northeast II*, 55 F.3d at 691; see also *Northeast I*, 993 F.2d 937, 961 (1st Cir. 1993).

91. *Northeast II*, 55 F.3d at 692.

92. *Northeast Utils. Serv. Co.*, 66 F.E.R.C. ¶ 61,332 (1994); see also *Florida Power & Light Co.*, 67 F.E.R.C. ¶ 61,141 (1994); *Southern Co. Servs., Inc.*, 67 F.E.R.C. ¶ 61,080 (1994).

should or should not be modified. However, the District of Columbia Circuit recently rejected a utility claim that the FERC had erred in refusing to apply the more flexible public interest standard by observing that the utility's section 206 request "does not involve the Commission proceed[ing] *sua sponte* or at the request of non-parties to change rates . . . in order to protect non-parties to a contract."<sup>93</sup>

While a substantive finding at the conclusion of a proceeding that third parties' interests are at stake and are damaged could be a legitimate factor in applying the more lenient public interest standard, the manner of initiating the investigation—*sua sponte* or at the request of a non-contracting party versus at the request of a contracting party—should have no bearing on the final Commission order. Section 206 of the FPA and section 5 of the NGA do not vest the Commission with different authorities based on the manner in which an investigation is initiated.<sup>94</sup> In addition, *Mobile's* extensive analysis of the Commission's authority over rates offers no support for the proposition that the Commission has greater contract revision authority in investigations initiated on its own motion than those in which a party to the contract has asked the Commission to revise a contract.<sup>95</sup> In either case, the public interest serves as the same predicate for the exercise of the Commission's rate revision authority. Moreover, a statutory construction granting the FERC greater authority to act *sua sponte* rather than on a party's request, plainly would produce arbitrary and unreasonable results since the manner of initiating the investigation could have outcome determinative effects. The hypothesis of two contracts each having equivalent public interest impacts is illustrative: a contract might be modified (whether or not it deserved to be) simply because the Commission itself initiated the investigation; whereas, an exactly equivalent contract would be shielded from the Commission's modification (whether or not it deserved to be) simply because the investigation was initiated at the request of a contracting party.

Implicit in this theory of *sua sponte* contract modification may be the notion that when acting *sua sponte* or at the request of non-contracting parties, the Commission is seeking to vindicate the public interest as opposed to the private interest, which is typically at center stage when a private party requests a contract modification.<sup>96</sup> However, the mere initiation of a proceeding by the Commission does not *ipso facto* establish that the public interest is involved, that the public interest is impaired, or that a contract change is justified. Similarly, the initiation of a proceeding by a private party does not preclude the presence of public interest considerations warranting reformation of the contract. In sum, the manner of initi-

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93. *Potomac Electric Power Co. v. FERC*, 210 F.3d 403, 408 (D.C. Cir. 2000) [hereinafter *PEPCO*], citing *Southern Co. Servs.*, 67 F.E.R.C. at 61,227 and *Florida Power*, 67 F.E.R.C. ¶ 61,080, at 61,399.

94. *United Gas Pipe Line Co., v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 342-43 (1956).

95. *Id.*

96. *PEPCO*, 210 F.3d at 409-10.

ating a contractual investigation ought not influence the final determination as to whether the public interest justifies or fails to justify a proposed contract modification. As noted above, *Northeast II* did not adopt the *sua sponte* rationale, while *PEPCO* referred to it in rejecting a contract amendment in a proceeding initiated by the complaint of a contracting party.

Evaluation of the *Northeast* decisions for their positive or negative contributions to *Mobile-Sierra* analysis should bring with it the recognition that those decisions, by increasing the FERC's latitude to prescribe contract modifications, are consistent with *Papago II* and *Kansas Cities*, which accord deference to the FERC regulation in restricting the rights of private parties to determine the terms of their own contractual relationship. The *Northeast* decisions also deal with a newly filed contract in which there has not been a long-standing history of mutual performance by both contracting parties. The Commission's modification of such a new contract in most instances would lack the inequitable side effects that would be produced when the Commission overturns a contractual arrangement that has governed the parties' relationship for several years. In the same vein, a newly filed contract is one which the Commission has not previously had the opportunity to evaluate, and thus there is a certain logic in allowing the Commission a threshold opportunity to modify (or at least reject) such a contract without adherence to the strict version of the *Mobile-Sierra* standard of contract reformation. Still another consideration suggesting that the *Northeast* decisions are easily reconcilable with basic *Mobile-Sierra* principles is the fact that the contract was between affiliates and did not involve the arms-length bargaining process that characterized the contracts reviewed in *Mobile*, *Sierra*, and succeeding cases.

From the service provider's point of view, perhaps the most disconcerting aspect of the *Northeast* decisions is the notion that given certain circumstances, the *Mobile-Sierra* standard may be less stringent when applied to efforts to reduce high rate contracts than to increase low rate contracts. Given the *Mobile* emphasis on the stability and adequacy of the energy supply, and given fluctuations in inflation, a high rate in a long-term contract in periods of lower costs should be entitled to as much protection as a low rate in a long-term contract in periods of rising costs. In both instances, the parties acting in mutual reliance have made substantial commitments to each other and assumed significant risks on each other's behalf. The seller foregoes the opportunity to sell its product at higher prices in the event of an increase in its own costs or in market prices. Conversely, the buyer foregoes the opportunity to purchase energy at lower prices in the event a less-expensive source of supply becomes available or it has reason to believe that the seller's costs have declined. Such contracts also create important public interest benefits. They ensure a stable supply of energy under terms, conditions, and rates that are established by the parties and that will remain in effect for the duration of their contractual rela-

tionship.<sup>97</sup> In fact, such contracts, or the prospects for entering into such contracts, are often the basis upon which new capacity is brought on stream. Any system of contract regulation that systematically fails to recognize those benefits and adopts a bias against supposedly "high rate" contracts will act as a deterrent to service providers entering into long-term contracts and to their making the underlying financial and supply commitments that make those contracts possible.

The *Northeast* decisions represent watershed developments in *Mobile-Sierra* analysis. They constitute the most significant interpretations of the *Mobile-Sierra* doctrine since *Papago II* and *Kansas Cities*, and are perhaps the most significant since the Supreme Court promulgated the doctrine in its *Mobile* and *Sierra* decisions. They represent a sharp change in FERC and judicial contract reformation analysis and drastically revise the *Mobile-Sierra* doctrine as it had been applied over the past forty years. Before the *Northeast* decisions, the three-pronged *Mobile-Sierra* test was treated as sacrosanct and as virtually impossible to satisfy in bilateral contract disputes. The best course of action for a party seeking to repudiate a bilateral contract was to argue that the contract permitted changes under the "just and reasonable" standard. Such an argument was necessary because if the *Mobile-Sierra* doctrine applied and if there were no overriding public policy considerations such as in the natural gas restructuring cases described above, the contract for all intents and purposes could never be changed, except by mutual consent. After the *Northeast* decisions, three standards of review apply to contract reformation: the "just and reasonable" standard, the classic "practically insurmountable" public interest standard, and the more lenient *Northeast* standard, which affords an expansive definition of the public interest considerations that would justify reformation of a bilateral contract.

#### VI. ORDER 888 AND THE FATE OF CONTRACTS IN THE ERA OF ELECTRIC RESTRUCTURING

Ongoing complementary initiatives by the FERC and state agencies are totally reshaping the electric industry in a manner that is producing a massive shift in regulatory jurisdiction from the states to the FERC. This shift occurs as the old vertically integrated arrangements, which were by-and-large subject to state jurisdiction, give way to new power marketing arrangements. These arrangements are characterized by significant increases in FERC jurisdictional wholesale sales in the chain between the power producer and the ultimate consumer, in the volume of FERC jurisdictional wholesale transmission service associated with those wholesale sales, and in the volume of "retail" transmission service, which occurs when generation and transmission services are unbundled and electricity is transmitted to the ultimate consumer over transmission facilities that are not owned by the electricity seller.

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97. *United Gas*, 350 U.S. at 344.

Order No. 888,<sup>98</sup> the Commission's major electric restructuring initiative, had to address the *Mobile-Sierra* rule among other things in order to deal with the stranded cost issues that were the consequence of electric restructuring. The FERC's more recent Order No. 2000 complements Order No. 888 by establishing the criteria by which transmission-owning utilities can band together to form regional transmission organizations (RTOs).<sup>99</sup> While future conflicts involving the RTOs created by Order No. 2000 and the *Mobile-Sierra* rule may emerge, Order No. 2000 itself does not have direct *Mobile-Sierra* implications.

Order No. 888 seeks to achieve open-access, non-discriminatory transmission service under standardized conditions available throughout the country. In the new open-access era, transmission-owning utilities would become common carriers obligated to provide service within the limits of available transmission capacity to all applicants that would be able to use their transmission facilities on the same basis that the transmission owners provide service to themselves. In this new open-access era, electric distribution systems—principally but not exclusively, municipally, and cooperatively owned distribution systems—would no longer be locked into electric purchases from the vertically integrated utilities to which they are directly interconnected. Instead, they would be entitled to use that utility's transmission system, as well as the systems of other utilities, to take service from the supplier offering power at the best available price on the best available terms.<sup>100</sup>

Based on its experience in restructuring the natural gas industry, the Commission recognized that it could not reorganize the wholesale electric industry without making provisions for the recovery of wholesale stranded costs.<sup>101</sup> Stranded costs could occur, because prior to Order No. 888 vertically integrated utilities served their wholesale distribution customers under contracts that had defined terms or so-called evergreen terms which provided for automatic contract renewal in the absence of an initiative by one party or the other to cancel the contract. However, the utilities' service relationships with their interconnected distribution systems were also affected by "supra-contractual" considerations. First, owing to transmission and other restrictions, some distribution systems did not have a physi-

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98. Order No. 888, *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [Regs. Preambles 1991-1996] III F.E.R.C. STATS. & REGS. ¶ 31,036 (1996), 61 Fed. Reg. 21,540 (1996); *order on reh'g*, Order No. 888-A, III F.E.R.C. STATS. & REGS. ¶ 31,048 (1997), 62 Fed. Reg. 12,274 (1997); *order on reh'g*, Order No. 888-B, 81 F.E.R.C. ¶ 61,248 (1997), 62 Fed. Reg. 64,688 (1997); *order on reh'g*, Order No. 888-C, 82 F.E.R.C. ¶ 61,046 (1998).

99. Order No. 2000, *Regional Transmission Organizations*, [Regs. Preambles] III F.E.R.C. STATS. & REGS. ¶ 31,089 (1999), *order on reh'g*, Order No. 2000-A, [Regs. Preambles] III F.E.R.C. STATS. & REGS., ¶ 31,092 (2000).

100. Order No. 888 did not mandate "retail wheeling." However, if retail wheeling is provided, either voluntarily by the utility or by order of a state regulatory agency, Order No. 888 requires that retail wheeling be provided under the terms of the transmission owner's standard, open-access tariff that is also used for wholesale wheeling purposes. Order No. 888, *supra* note 98, at 31,784.

101. Order No. 888, *supra* note 98, at 31,789.

cal or economically feasible alternative to the service provided by their local vertically integrated utility. Second, utilities operated under a public interest duty to serve. As a consequence of those supra-contractual considerations, the utilities' expectations to serve their wholesale customers exceeded the duration of their contractual obligations. The result of the supra-contractual considerations was that the life of the investments and other financial commitments made by those utilities to serve those customers exceeded the lives of their contracts.<sup>102</sup>

The Commission's concern was that the opening up of the power supply markets through Order No. 888 could cause utilities, who made substantial financial commitments in the pre-open-access period based on *bona fide* expectations of serving and on obligations to serve customers, would experience stranded costs as those customers' contracts expired and the customers began to exploit power supply options available in the open market. Stranded costs result because generating capacity can become underutilized when a customer unexpectedly terminates service, or because the embedded cost of generating capacity which is recovered under traditional cost of service ratemaking procedures exceeds the price at which generating capacity previously dedicated to a customer could be sold on the open market.<sup>103</sup>

The Commission set out its general policy on stranded costs in the following terms:

We reaffirm our preliminary determination that the recovery of legitimate, prudent and verifiable stranded costs should be allowed. . . . [W]e continue to believe that utilities that entered into contracts to make wholesale requirements sales under an entirely different regulatory regime should have an opportunity to recover stranded costs. . . . [W]e do not believe that utilities that made large capital expenditures or long-term contractual commitments to buy power years ago should now be held responsible for failing to foresee the actions this Commission would take to alter the use of their transmission systems in response to the fundamental changes that are taking place in the industry.<sup>104</sup>

In Order No. 888-A, the Commission reiterated:

The most critical transition issue that arises . . . is how to deal with the uneconomic sunk costs that utilities prudently incurred under an industry regime that rested on a regulatory framework and a set of expectations that are being fundamentally altered.<sup>105</sup>

Accordingly, the Commission in Order Nos. 888 and 888-A made generic findings that it would be in the public interest to allow utilities to modify wholesale requirements contracts which predate July 12, 1994,<sup>106</sup> in

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102. *Id.* at 31,790-91.

103. Order No. 888, *supra* note 98, at 31,788-89.

104. *Id.* at 31,788-89.

105. Order No. 888-A, *supra* note 98, at 30,346.

106. This marked the issuance of the initial notice of proposed rulemaking (NOPR) which led to Order No. 888 (Notice of Proposed Rule Making, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, [Proposed Regs. 1988-1998] IV F.E.R.C. STATS. & REGS. ¶ 32,507, 59 Fed. Reg. 35,274 (1994)). The FERC reasoned that issuance of the NOPR placed utilities on notice that their ser-

order to include stranded cost provisions. For example, a utility with a ten-year contract ending November 1, 2000, is given the unilateral right to amend the contract by adding a provision that authorizes the utility to bill the customer for any stranded costs which the utility might incur by reason of the customer's termination of that service in accordance with its rights under the contract.

Order No. 888 implemented a two-stage approach to utility stranded cost recovery. The first stage was the generic stage which was accomplished through Order No. 888's across-the-board finding that it was in the public interest, as defined by the *Mobile-Sierra* rule, to allow utilities to recover wholesale stranded costs provided they could sustain their burden of proof on the "stage two" issues. The second stage is the utility-specific stage in which a utility must demonstrate, among other things: (1) its reasonable expectation to serve; (2) the beginning and end of the stranded cost recovery period; and (3) the validity of its estimate of stranded costs (represented by the difference between its effective rates at the time of contract termination and the market rates for electricity).

The Commission, in refusing to apply the "practically insurmountable" *Mobile-Sierra* standard where utilities request a unilateral modification of their contracts in order to include stranded cost amendments, relied in part on the First Circuit's *Northeast* decisions.<sup>107</sup> The Commission stated that its stranded cost rulings should not be subject to the "practically insurmountable" standard from 'the classic "low rate" case, namely, *Papago*.'"<sup>108</sup> It also asserted that its stranded cost amendments protected not only the utility providing service, but also "non-parties" to the contract.<sup>109</sup> In addition, in relying on *Northeast* to justify unilateral stranded cost amendments which increase rates, the Commission applied the *Northeast* doctrine to a "low" rate case.<sup>110</sup>

Instead of limiting *Mobile-Sierra* relief to utilities, the Commission made complementary *Mobile-Sierra* public interest findings, creating a symmetry of rights between utilities and their wholesale requirements customers. In addition to allowing utilities the right to add stranded cost amendments to their requirements contracts, the Commission also gave wholesale requirements customers the right to modify their contracts under the just-and-reasonable standard rather than the classic *Mobile-Sierra*

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vice arrangements with their wholesale distribution customers was subject to change so that any contracts postdating July 11, 1994 should contain specific provisions regarding stranded cost and service termination.

107. Order No. 888-A, *supra* note 98, at 30,192-94, 30,400-01.

108. Order No. 888-A, *supra* note 98, at 30,400.

109. Order No. 888 allows stranded cost recovery chiefly for wholesale stranded costs, which it defines as incurred when the wholesale customer uses the stranded cost applicant's transmission system to purchase power on the open market. Except in limited circumstances, stranded cost recovery is not permitted for retail stranded costs, which Order No. 888 defines as occurring in retail wheeling circumstances. See *supra* note 66. See also Order No. 888-A, *supra* note 98 at 30,400-01.

110. See discussion *supra* Part V.



public interest test.<sup>111</sup> The Commission gave consideration to a generic rule abrogating all wholesale requirements contracts. However, the Commission expressly found in Order 888 that there was no market failure in the electric industry that would justify generic modification of requirements contracts.<sup>112</sup> Of course, a generic abrogation of all contracts for wholesale requirements service would have produced chaos, confronting some utilities with huge stranded cost bills and some customers with critical shortages of supply.

In allowing wholesale requirements customers the right to modify their contracts based on just-and-reasonable rather than public-interest criteria, the Commission's commentary largely, although not exclusively, emphasized the relationship between stranded cost relief for utilities and contract termination by customers. Thus, the inference could be drawn that the contract relief available to customers would be limited to early termination of their contracts. The Commission stated that its public interest finding relative to customers obtaining the opportunity to participate in the wholesale power markets "complements" its finding regarding stranded cost recovery.<sup>113</sup> In considering the procedures that would be followed in post-Order No. 888 cases, the Commission explained that the most productive way to analyze impending contract modifications would be to simultaneously consider both a customer's request to shorten or terminate a contract and the selling utility's request for stranded cost recovery.<sup>114</sup>

In stating that it did not "take contract modification lightly," the Commission explicitly juxtaposed "a utility . . . seeking a contract amendment to permit stranded cost recovery based on expectations beyond the stated term of [its] contract" and a customer "seeking to shorten or eliminate the term of an existing contract. . . ."<sup>115</sup> The Commission's Order No. 888 public interest finding regarding customer contract modifications was expressly predicated on allowing customers to seek new sources of supply. The Commission stated: "it would be against the public interest to permit a *Mobile-Sierra* clause in an existing wholesale requirements contract to preclude the parties to such a contract from the opportunity to realize the benefits of the competitive wholesale power markets."<sup>116</sup>

Order No. 888-A further emphasized a balanced approach with respect to customer contract amendments directed at accelerating customer opportunity to participate in power supply markets. Order No. 888-A states: "Our goal is to balance the desire to honor existing contractual arrangements with the need to provide some means to accelerate the oppor-

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111. Order No. 888, *supra* note 98, at 31,664.

112. *Id.* at 31,664-65.

113. Order No. 888, *supra* note 98, at 31,664.

114. *Id.* at 31,036-37.

115. Order No. 888, *supra* note 98, at 31,665.

116. *Id.* at 31,664.

tunities of parties to participate in competitive markets.”<sup>117</sup>

However, Order No. 888-A also contained language indicating that customers would not be subject to the *Mobile-Sierra* standard for changes in addition to contract duration changes. Seeming to expand its Order No. 888 customer-related contract modification analysis, the Commission explained that requirements customers “will be able to effectuate any change [to their contracts] by satisfying a just and reasonable standard.”<sup>118</sup> Construed within the context of Order No. 888’s overall purpose, it is possible to narrowly interpret the term “any change” as referring to any contract change related to the term of a contract, notice, and other provisions related to the term of the contract. However, a broader interpretation is also possible. A possible premise for such a broader interpretation is that some requirements customers were subject to unreasonable contract terms which the utility was able to impose through the discriminatory withholding of transmission service prior to Order No. 888.<sup>119</sup> However, as noted above, Order No. 888 found no systemic pre-Order No. 888 market failures that would justify generic abrogation of all power supply contracts.

An obvious nexus exists between allowing requirements customers to shorten or terminate pre-Order No. 888 contracts and allowing utility-proposed stranded cost amendments that have the financial effect of extending the terms of their contracts. In both instances, application of the same contract reformation standard altering the contract term is appropriate. However, the existence of a direct nexus between stranded cost amendments and allowing requirements customers to seek “non-duration” contract modifications under the just and reasonable standard is not as readily apparent. Such broader customer rights are not consistent with the balanced approach that Order No. 888 envisioned or with its purpose, which was to permit requirements customers to obtain access to newly opened wholesale markets. Such an asymmetry in contract rights between the utility and its customers could also result in a failure of the mutuality of consideration underlying wholesale requirements contracts. This is because customers could seek *Mobile-Sierra* protection of contractual benefits including, but not limited to, the long-term certainty of supply, the fixed nature of the capacity rates and bundled generation, and transmission service, while seeking to change (under the just and reasonable standard) on a piecemeal basis, only the term or terms that no longer suit them (most likely, but not necessarily, limited to the level of the rates). For example, customers under requirements contracts which typically contain recitals that “each term is in consideration for every other term,” would be able to reduce a rate in a long-term contract under the just and reasonable standard and at the same time preclude the utility from shortening the term of the contract except under the public interest standard. Assuming Order No. 888-A did intend to eliminate the *Mobile-Sierra* doctrine for all

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117. Order No. 888-A, *supra* note 98, at 30,192.

118. *Id.* at 30,193 n.35.

119. Order No. 888-A, *supra* note 98, at 30,193.

customer-initiated contract modifications, the question remains whether such a result was compelled by the Commission's Order No. 888 findings or whether the Commission exploited an opportunity to rid itself of a constraint which for years it had viewed as a vexatious restriction on its regulatory authority.

Finally, the Commission stated that it did not take contract revision lightly, and that a utility seeking to add a stranded cost amendment would have a "high evidentiary burden."<sup>120</sup> According to the Commission, a utility proponent of a stranded cost amendment or a customer proponent of a contract change must each satisfy not merely a conventional just-and-reasonable burden, but rather must sustain a heavier burden of proof to justify amending the contract.<sup>121</sup> As a consequence of those rulings, several different standards apply to contract changes depending on the nature of the contract, the nature of the contract revision, and the identity of the proponent of the contract change. The applicable standards include: (1) the classic three-pronged *Mobile-Sierra* public interest standard; (2) the more flexible public interest standard developed in *Northeast*; (3) the Order No. 888 "heavy burden" standard; and (4) the traditional just and reasonable standard. The existence of those standards may provide a rich broth for future contract litigation.

The D.C. Circuit affirmed Order Nos. 888 and 888-A almost in their entirety.<sup>122</sup> Observing that *Mobile-Sierra* determinations were typically made on a case-by-case basis, the court found no flaw in the Commission's departure from the case-by-case determination through its "two generic public interest findings, one focused on utilities, the other on customers."<sup>123</sup> According to the court, the Commission's generic finding regarding utility stranded cost contract amendments was justified by the financial impairment to utilities and the weakening of their ability to provide service without stranded cost recovery. The court also relied on the fact that open-access transmission "affect[s] an entire class of contracts in an identical manner."<sup>124</sup> The court then stated: "we find nothing in the *Mobile-Sierra* doctrine to prohibit [the] FERC from responding with a public interest finding applicable to all contracts of that class."<sup>125</sup> The court also took comfort from the two-stage nature of the stranded cost recovery process, the generic relaxation of the public interest standard, and the stage two findings which it said added "a particularized element to [the] FERC's generic public interest finding."<sup>126</sup> Without referring to the NGA contract modifications discussed above, the court concluded by stating that generic *Mobile-Sierra* findings would be "appropriate only in rare circumstances,"

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120. *Id.* at 30,192.

121. Order No. 888, *supra* note 98, at 31,664-65.

122. Transmission Access Policy Study Group v. FERC, No. 97-1715, (D.C. Cir. June 30, 2000).

123. Transmission Access Policy Study Group, No. 97-1715, slip op. at 58.

124. *Id.* at 60.

125. Transmission Access Policy Study Group, No. 97-1715, slip op. at 60.

126. *Id.* at 60.

but that Order No. 888, which fundamentally changes the regulatory environment, "is just such a circumstance."<sup>127</sup>

According to the court, the Commission's generic finding with respect to customer-initiated contract amendments was justified by the Commission's finding that discrimination and unequal bargaining power existed in the pre-open-access era.<sup>128</sup> Interpreting Order Nos. 888 and 888-A as allowing extensive customer-initiated contract revisions under the just and reasonable standard, the court also affirmed the "FERC['s] . . . justifications for affording customers a broader opportunity than utilities to modify their contracts," particularly in cases of discrimination which existed prior to Order No. 888, and the fact that in the post-Order No. 888 period those pre-existing contracts may no longer be just and reasonable and may cause harm to third parties (i.e., the consumers served by the direct customers of the utility).<sup>129</sup> The court's concluding statement was: "Remedying potential unfairness to utilities by allowing them to seek stranded cost recovery if a customer shortens the term of a contract . . . [strikes] a balance between customers and utilities that can[not easily] . . . be characterized as arbitrary or capricious."<sup>130</sup> However, that statement would be more consistent with restricting customers to contract duration changes rather than allowing them to also seek changes to any other provisions of their contracts.

Eliminating *Mobile-Sierra* requirements for all customer-initiated rate changes in requirements contracts which predate July 12, 1994, limits the potential future application of the *Mobile-Sierra* rule in electric utility cases to: (1) non-requirements contracts; (2) service providers seeking non-stranded cost amendments to their requirements contracts; and (3) customers seeking revisions to their post-July 11, 1994 contracts. In effect, based on that interpretation, the Commission in a single stroke eliminates the *Mobile-Sierra* doctrine as a restriction on its right to make customer-beneficial modifications to pre-July 12, 1994 requirements contracts.<sup>131</sup>

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127. Transmission Access Policy Study Group, No. 97-1715, slip op. at 60.

128. *Id.* at 60.

129. Transmission Access Policy Study Group, No. 97-1715, slip op. at 63. See discussion *infra* Part VI.

130. *Id.* at 63-64.

131. In *French Broad Elec. Membership Corp. v. Carolina Power & Light Co.*, 92 F.E.R.C. ¶ 61,283 (2000), its first case to deal with the issue following the *Transmission Access Study Group* decision, the FERC asserted that its intent in Order No. 888 was to relieve customers from satisfying *Mobile-Sierra* requirements for any changes they might propose to pre-July 12, 1994, contracts and that its references to shortening or terminating the term of a contract were merely "examples" of the kinds of modifications a customer might seek. Nevertheless, applying the just and reasonable standard, the FERC rejected the customer proposed modifications in that case on the ground that the contract was a long-term contract and that the customer's evidence failed to satisfy a "life-of-the-contract" standard, i.e., failed to show that the contract would be unjust and unreasonable over its entire life rather than a specific period within the contract term.

## VII. BILATERAL ANALYSIS REVISITED

There are three recent D.C. Circuit cases that have addressed the *Mobile-Sierra* issue: *Union Pacific Fuels (Union Pacific)*,<sup>132</sup> *Texaco*,<sup>133</sup> and *Potomac Electric Power Company (PEPCO)*.<sup>134</sup> The first two cases involve both bilateral and public policy issues. *PEPCO* was an effort by one utility to reduce the transmission rate charged to it by another utility.

*Union Pacific*. Kern River Gas Transmission Company had used the optional certificate procedures<sup>135</sup> which expedite the issuance of a certificate to construct a pipeline and require the sponsor to assume the economic risks of pipeline construction. Kern River negotiated contracts with shippers to include the modified fixed/variable (MFV) rate design, as well as "Memphis" clauses allowing Kern River to change all but two of the shippers' rates unilaterally under section 4 of the NGA. The two exceptions were contracts with Mobil Gas & Exploration (Mobil) and Union Pacific. Those contracts included clauses expressly guaranteeing that Kern River would not change the MFV rate design without the customers' consent.

The Commission's 1992 Order No. 636 included an alteration of the required rate design from MFV to straight fixed/variable (SFV), which passed pipeline costs on to shippers by assigning all fixed costs to a reservation charge based on peak use and all variable costs to a usage charge based on commodity takes.<sup>136</sup> The court described SFV more closely than MFV as reflecting the incremental cost of producing and transporting the gas in order to create a more competitive and efficient market while incidentally shifting risks and burdens from the pipeline to the shipper.<sup>137</sup> Taking advantage of this risk reallocation, Kern River filed with the Commission to change the rate design from MFV to SFV for all its customers except Mobil and Union Pacific. The Commission responded with an order accepting the rate design change as to those customers and imposed the rate design change on the Mobil and Union Pacific contracts as well.

The shippers appealed, contending, among other things, that Kern River's risk reallocation undercut the understandings pursuant to which the optional certificate was issued. The court disposed of those claims by observing that the contracts, other than the Mobil and Union Pacific contracts, included "Memphis" clauses, allowing the parties, and thereby the Commission, to change the rate design under the just and reasonable stan-

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132. *Union Pacific Fuel, Inc. v. FERC*, 129 F.3d 157 (D.C. Cir. 1997), *aff'g Kern River Gas Transmission Co.*, 62 F.E.R.C. ¶ 61,191 (1993), *reh'g denied*, 64 F.E.R.C. ¶ 61,049 (1993).

133. *Texaco, Inc. v. FERC*, 148 F.3d 1091 (D.C. Cir. 1998), *aff'g Mojave Pipeline Co.*, 62 F.E.R.C. ¶ 61,195 (1993), *reh'g denied*, 64 F.E.R.C. ¶ 61,047, *reh'g denied*, 65 F.E.R.C. ¶ 61,059 (1993).

134. *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403 (D.C. Cir. 2000), *aff'g Potomac Elec. Power Co. v. Allegheny Power Sys.*, 85 F.E.R.C. ¶ 61,160 (1998), *reh'g denied*, 87 F.E.R.C. ¶ 61,030 (1999).

135. *See generally* 18 C.F.R. §§ 157.100-06 (2000).

136. Order No. 636, *supra* note 58, at 30,434.

137. *Union Pacific Fuel*, 129 F.3d at 160.

dard.<sup>138</sup> The court went on to hold that the FERC could change the Mobil and Union Pacific rate designs under the just and reasonable standard. The court distinguished between restrictions on the contracting parties' rate change rights and restrictions on the Commission's rate change rights. Citing *Papago II*, the court said that the language restricting the parties' rate change rights to the *Mobile-Sierra* standard did not so restrict the Commission in the absence of language expressly limiting the Commission's *Mobile-Sierra* public-interest standard of contract review.<sup>139</sup> Without such express language, the court held that the *Mobile-Sierra* doctrine was inapplicable to rate design changes initiated by the Commission. Thus, the contracts were interpreted as precluding Kern River from seeking rate design modifications except under the public interest standard but not foreclosing the Commission from imposing such modifications pursuant to the just and reasonable standard.

*Texaco*. *Texaco*, decided only eight months after *Union Pacific*, effectively modified *Union Pacific*. *Texaco* also dealt with contracts on both a bilateral and public policy basis and involved a rate design change from MFV to SFV. In a November 1992 rate filing made shortly after Order No. 636 was issued, Mojave Pipeline Company proposed to retain its MFV rate design for existing customers but to adopt an SFV rate design for new customers.<sup>140</sup> The Commission accepted this filing as to new customers, but rejected the filing insofar as it would retain MFV pricing for existing customers, and required the pipeline to adopt SFV rates for all customers. In rejecting the shippers' *Mobile-Sierra* contentions, the FERC relied on the fact that the contract between the parties expressly prohibited unilateral rate changes under section 4 of the NGA but contained no express limitation on the FERC's own contract modification authority. The FERC found this contractual silence as an implicit recognition of its authority to modify the rates on just and reasonable grounds under section 5 of the NGA.<sup>141</sup> Consistent with *Union Pacific*, the FERC's rationale was that the parties had to refer specifically to their service agreements to bind the Commission under the public interest standard. The shippers served by Mojave, including *Texaco*, appealed and claimed that the Commission was precluded by contract from ordering the conversion to the SFV rate design.

In reversing the FERC's ruling, *Texaco* noted *Union Pacific's* quotation from *Papago*: "A contract between private parties may preserve [the] FERC's right to impose new rates by 'leav[ing] unaffected the power of the Commission . . . to replace not only rates that are contrary to the public interest but also rates that are unjust [or] unreasonable.'" <sup>142</sup>

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138. *Id.* at 161.

139. *Papago II*, 723 F.2d 950, 953 (D.C. Cir. 1983).

140. *Mojave Pipeline Co.*, 62 F.E.R.C. ¶ 61,195, 62,362 (1993).

141. *Kern River Gas Transmission Co.*, 62 F.E.R.C. ¶ 61,191, 62,260-61 (1993).

142. *Texaco, Inc. v. FERC*, 148 F.3d 1091, 1096 (D.C. Cir. 1998) (emphasis added); *Papago II*, 723 F.2d 950, at 953 (D.C. Cir. 1983); *Union Pacific Fuel, Inc. v. FERC*, 129 F.3d 157 (D.C. Cir. 1997).

Characterizing that quotation as “misleading” and as not “represent[ing] the law,” the court rejected the notion that any particular language was required to invoke the *Mobile-Sierra* public-interest standard and to bind the Commission to that standard.<sup>143</sup> It stated that “[t]he law is quite clear: absent contractual language ‘susceptible to the construction that the rate may be altered while the contract[] subsist[s]’ the *Mobile-Sierra* doctrine applies.”<sup>144</sup> Accordingly, the court held that it was necessary to look at the language of the contract to determine whether or not the parties had intended to deny themselves the ability to modify their rates. If the parties had denied themselves that ability, the Commission was also prevented from modifying the contract except in accordance with the *Mobile-Sierra* public interest criteria. This was a subtle, but nonetheless a direct reversal of the *Union Pacific* ruling that a contract could expressly limit the parties to public interest changes, but *sub silentio* not bind the Commission. Needless to say, the parties could write a contract that bound themselves to the public-interest standard but expressly allowed the Commission to make changes under the just and reasonable standard. However, absent such an explicit reservation of the Commission’s rights, *Texaco* holds that the public-interest test applies to the Commission if it applies to the contracting parties.

The court also rejected the Commission’s reliance on RAC, which bound the parties to “comply with all applicable laws, statutes, ordinances. . . .”<sup>145</sup> The court said that the clause was merely a generic contract clause compelling both parties to adhere to the law and did not contemplate changes in rates. In other words, the court viewed the clause as similar to the clause in *Gulf States Utilities*, which was held to refer to regulation in general rather than rate adjustment in particular.<sup>146</sup> The court described the RAC as “banal” and irrelevant to rate setting. The court reviewed the contracts and concluded they were not intended to give Mojave unilateral authority to modify its transmission rates but rather were intended to establish a rate that was “changeable” only in a specific manner.<sup>147</sup> Thus, *Texaco* reached back to basic *Mobile-Sierra* principles and effectively construed its prior *Union Pacific* decision as having strayed from those principles.

Determining that the *Mobile-Sierra* doctrine was applicable did not end the matter. The court recognized that the Commission could reform the contracts if a public interest showing could be made that would justify the reformation. In the orders underlying the *Texaco* appeal, the Commission had relied on an Order No. 636 public interest rationale.<sup>148</sup> The court

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143. *Texaco*, 148 F.3d at 1091.

144. *Texaco*, 148 F.3d at 1096 (citing *Appalachian Power Co. v. FPC*, 529 F.2d 342, 348 (D.C. Cir. 1976)).

145. *Id.* at 1096.

146. *Texaco*, 148 F.3d at 1096.

147. *Id.* (citing *Richmond Power & Light Co. v. FPC*, 481 F.2d 490, 497 (D.C. Cir. 1993)).

148. *Texaco, Inc. v. FERC*, 148 F.3d 1091, 1096-97 (D.C. Cir. 1998) (citing *Kern River Gas Transmission Company*, 64 F.E.R.C. 61,049, 61,383 (1993)).

Commission was proceeding *sua sponte* or at the request of non-parties to change rates. It noted that PEPCO was a party and that PEPCO had failed to offer any evidence beyond speculation that non-parties would be injured by the contract. The court also observed that *Northeast* involved the FERC's first look at a contract and expressed the concern that the "practically insurmountable" *Mobile-Sierra* doctrine would be inappropriate to apply to the FERC's first review of a contract. On that basis, the court concluded that the circumstances that were present in the *Northeast* proceeding were not present in the *PEPCO* proceeding.<sup>162</sup>

The court also disposed of PEPCO's contention that it had not willingly entered into the contract with APS and did so only because of the absence of transmission alternatives. The court said that the premise of the Commission's ruling was not PEPCO's willingness to enter into the contract, but rather that the Commission does not take contract modification lightly and that PEPCO had failed to demonstrate that revision of the contract was warranted by the public interest. The court also disputed PEPCO's assertions that the contracting process was tainted by discrimination, and noted that PEPCO, at the time of the rate filing, had asserted that the rate was reasonable and that it had other alternatives. The court said that in the absence of unfairness or bad faith in the contract formation process it was reasonable for the Commission to require the parties "to live with their bargains as time passes and various projections about the future are proved correct or incorrect."<sup>163</sup> The court also approved the Commission's refusal to apply its Order No. 888-A requirements contract policy to non-requirements contracts.<sup>164</sup>

### VIII. CONCLUSION

The *Mobile-Sierra* doctrine is akin to a dark and arcane science. Its basic principles are simply stated. However, they are steeped in nuance and are treacherously difficult to apply, as demonstrated by the recent "dialogue" between the D.C. Circuit's decisions in the *Union Pacific* and *Texaco* cases, and by the somewhat less recent First Circuit *Northeast* decisions which challenged the basic premises upon which the *Mobile-Sierra* doctrine had been interpreted and applied during the preceding forty years of its existence. Throughout the period since the *Mobile* and *Sierra* cases were decided, the Commission and the courts have wrestled with issues related to contract interpretation, contract rights, statutory rights, judicial deference to agency expertise, and public policy.

The legacy of the Supreme Court's decisions in the *Mobile* and *Sierra* cases has been a complex allocation of rights and responsibilities. Private parties have the right to establish the terms of their own contractual relationships, but this right is subordinate to the Commission's public interest authority. Parties to contract litigation have different rights depending on

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162. *Id.* at 408-09.

163. *PEPCO*, 210 F.3d at 409 (citing *Norwood*, 587 F.2d at 1312-13).

164. *PEPCO*, 210 F.3d at 409-11.



the type of contract and on their status as: the service provider, the service recipient, or a non-contracting party who is nonetheless affected by the contract. Finally, the role of the Commission itself depends on the function it is performing in any given setting. If it acts as an adjudicator of private contract disputes, the Commission must determine whether the *Mobile-Sierra* rule applies. If the *Mobile-Sierra* rule does apply, the Commission must decide whether or not public interest considerations are present thereby warranting modification of the contract. The Commission's second role arises when it acts generically to vindicate broad public policy objectives through its public interest authority. When acting in the latter role, the Commission's contract reformation authority is at its zenith.

In the modern era of restructuring, the question arises whether the *Mobile-Sierra* doctrine has ongoing viability or will become a historical artifact. On the natural gas side of the Commission's jurisdiction, the potential for *Mobile-Sierra* disputes is greatly reduced. The Commission no longer has jurisdiction to regulate commodity prices in the first sale of natural gas by producers.<sup>165</sup> Natural gas transportation rates remain substantially regulated under the NGA, but the service is provided pursuant to tariffs and service agreements which, as a standard matter, reserve the pipeline's right to change the tariff terms and conditions under the provisions of the NGA section 4. Nevertheless, the *Union Pacific* and *Texaco* decisions do indicate that the potential for future *Mobile-Sierra* litigation in the natural gas industry is not totally exhausted.

The prospects for future *Mobile-Sierra* litigation under the FPA are similarly diminished. Except for grandfathered agreements, transmission service is now provided under generic transmission tariffs that conform to the requirements of Order No. 888. Electricity sales are frequently made at market-based rates and under standardized short-term contracts in which the buyers and sellers fashion the final terms of their agreement by telephone and then reduce them to writing on an after-the-fact basis. For utilities operating in certain areas, particularly with large power pools, a large volume of spot-market transactions is conducted. Sales are also taking place through power exchange forward markets extending from "day-of" transactions to transactions on a "year-ahead" basis or longer. These developments suggest that in the future the arch-typical long-term requirements contracts, which figured in much of the past *Mobile-Sierra* litigation, will play a smaller role in the future. These developments have significantly reduced the potential for *Mobile-Sierra* litigation.

Nevertheless, the transition to deregulated electricity markets is not occurring without incident. Complaints continue to be filed by customers against utilities and *vice versa*. Also, complaints are regularly filed against the independent system operators. Price volatility, at least on a short-term basis, has impelled the Commission to take the controversial step of imposing price caps, which the Commission acknowledges are inconsistent with notions of long-term competitive markets, in various ISO markets. In

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165. Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, § 2(b), 103 Stat.158 (1989).

addition, the heterogeneity of the electric industry suggests the likelihood of persistent conflicts among transmission-owning utilities, non-transmission owning distribution systems, generators, marketers, consumer groups, and the independent system operators soon to become the regional transmission organizations. These disputes are fueled not merely by high prices, but by concerns over the adequacy of the electric supply and the need to undertake and coordinate additional transmission construction. Given these facts, the likelihood of future contract disputes cannot be viewed as *de minimis*. Thus, while the volume of *Mobile-Sierra* litigation is apt to decline, it is very likely that the last of the cases addressing the intricacies of the "refreshingly simple" *Mobile-Sierra* analysis has yet to be seen.