MORGAN STANLEY CAPITAL GROUP, INC. V. PUBLIC UTILITY DISTRICT NO. 1 REVISITS THE MOBILE-SIERRA DOCTRINE: SOME ANSWERS, MORE QUESTIONS

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Synopsis: In *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1 of Snohomish County, Washington*,[1] the Supreme Court provided its most detailed exposition of the *Mobile-Sierra* doctrine since the Court decided the doctrine's namesake cases in 1956. This article describes the *Morgan Stanley* ruling, including the relevant aspects of the underlying proceedings before the Federal Energy Regulatory Commission (FERC) and the United States Court of Appeals for the Ninth Circuit.

Morgan Stanley clarifies a number of important issues related to the *Mobile-Sierra* doctrine, and, in so doing, reaffirms the role of contracts in the regulatory scheme established by the Federal Power Act (FPA) and the Natural Gas Act (NGA). Further, while explicitly declining to reach the issue of whether the FERC's market-based rate program for electricity sales complies with the FPA, *Morgan Stanley* indicates that the *Mobile-Sierra* presumption applies to bilateral market-based rate contracts and finds that market dysfunction that affects a contract rate is alone not sufficient grounds to refuse to apply the *Mobile-Sierra* presumption of justness and reasonableness.

The ruling, however, leaves unanswered questions concerning the scope of the FERC's authority to modify jurisdictional contracts under *Mobile-Sierra*. In particular, the Court's conclusion that the *Mobile-Sierra* presumption–that a contract is just and reasonable–does not depend on the FERC having had an initial opportunity to review the contract without applying the presumption may prompt arguments that the FERC has limited authority to reject contracts–including negotiated settlements–even where the contracts fail to adhere to the FERC's policies and regulations. The Court's ruling on the "initial opportunity" issue also raises the stakes with respect to the issue of whether non-parties to a contract must overcome the *Mobile-Sierra* presumption of justness and reasonableness in challenging a jurisdictional contract. Similarly, the Court's discussion of the circumstances where the *Mobile-Sierra* presumption does not apply, and the showing necessary to overcome the presumption, presents issues that will need to be resolved by the FERC in the years to come.

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1. 128 S. Ct. 2733 (2008) [hereinafter *Morgan Stanley*].

I. INTRODUCTION

On June 26, 2008–the final day of the 2007 term–the U. S. Supreme Court issued its eagerly-awaited ruling in *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1 of Snohomish County, Washington*.[2] The ruling, which reviewed a decision by the United States Court of Appeals for the Ninth Circuit addressing orders of the FERC, represented the Court's most detailed exposition–in more than fifty years–of its seminal decisions in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*[3] and *Federal Power Commission v. Sierra Pacific Power Co.*[4]

Considering FERC orders on complaints filed under Section 206 of the Federal Power Act (FPA)[5] which challenged wholesale contracts to purchase electricity executed during the 2000-2001 power crisis in the western United

2. *Id*.
3. 350 U.S. 332 (1956) [hereinafter *Mobile*].
4. 350 U.S. 348 (1956) [hereinafter *Sierra*].
5. 16 U.S.C. § 824e (2006).

States, four justices endorsed the principle that the "*Mobile-Sierra* doctrine" generally requires the FERC to "presume that the rate set out in a freely negotiated wholesale-energy contract meets the 'just and reasonable' requirement imposed by law. The presumption may be overcome only if the FERC concludes that the contract seriously harms the public interest."[6] The presumption, the Court explained, is grounded in the notion that the sophisticated parties to a wholesale energy transaction can be expected to negotiate a just and reasonable rate between them, and the presumption is not dependent upon the FERC having had a prior opportunity to review the contract.[7]

Although finding fault with two aspects of the FERC orders at issue and affirming the judgment of the Ninth Circuit that a remand was necessary, the Supreme Court's *Morgan Stanley* decision, on balance, represents a strong endorsement of contract integrity under the regulatory scheme governed by the FPA and the Natural Gas Act (NGA). The decision, however, also raises numerous questions regarding the extent of the FERC's authority to modify jurisdictional contracts–questions that the FERC likely will be forced to confront in the years to come.

This article briefly reviews the development of the *Mobile-Sierra* doctrine and then describes the Supreme Court's ruling in *Morgan Stanley*, including the background of the case before the FERC and the Ninth Circuit. The article goes on to discuss the ways in which *Morgan Stanley* has provided greater clarity regarding the operation of the *Mobile-Sierra* doctrine and also looks at a number of areas where *Morgan Stanley* is likely to prompt disputes concerning the application of the doctrine.

II. DEVELOPMENT OF THE *MOBILE-SIERRA* DOCTRINE

The Supreme Court decided *Mobile* and *Sierra* on the same day in 1956. The basic question presented in each case was the same: may a utility subject to the Federal Power Commission's (FPC)[8] jurisdiction file to increase the rates contained in an FPC-jurisdictional bilateral contract without the consent of its counterparty?[9] In *Mobile*, the FPC had allowed a natural gas pipeline to increase the rate charged to a particular wholesale customer notwithstanding a contract between the pipeline and the customer specifying a lower rate.[10] The FPC had concluded that interstate pipelines always retain the right under Section 4 of the NGA to file a new rate, subject only to the FPC's authority under Section 4(e) of the NGA to find the rate unlawful.[11] Reasoning that the NGA "permits the

6. *Morgan Stanley*, 128 S. Ct. at 2737.

7. *Id*. at 2746.

8. Pursuant to the Department of Energy Organization Act, Public Law 95-91, 91 Stat. 565 (August 4, 1977), and Executive Order No. 12009, 42 Fed. Reg. 46,267 (September 15, 1977), the FPC ceased to exist on October 1, 1977 and its functions and regulatory responsibilities were transferred to the Secretary of Energy and the FERC, which was activated on October 1, 1977. *See, e.g., Public Serv. Co. of N.H.*, 1 F.E.R.C. ¶ 61,002 at p. 61,001 (1977).

9. *Mobile* arose under the NGA, while *Sierra* arose under the FPA. As the Court explained in *Sierra*, however, "the provisions of the Federal Power Act relevant to this question are in all material respects substantially identical to the equivalent provisions of the Natural Gas Act." *Sierra*, 350 U.S. at 353.

10. *Mobile*, 350 U.S. at 333-334.

11. *Id*. at 336-37 (citing section 4(e) of the NGA, 15 U.S.C. § 717c(e) (2006)).

relations between the parties to be established initially by contract,"[12] the Supreme Court found that the NGA did not authorize the pipeline unilaterally to change the contract rate by filing a new rate under NGA Section 4.[13] The rate-filing provisions of Section 4, the Court concluded, specified the *process* a natural gas company must use to change a rate, but did not constitute "a grant of power" to modify valid contract rates.[14]

The Court explained that its conclusion "fully promote[d] the purposes of the Act,"[15] which "[b]y preserving the integrity of contracts . . . permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry."[16] The Court observed, however, that "denying to 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."[17] The Court concluded in this regard that the NGA "affords a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other."[18]

In its companion decision in *Sierra*, the Supreme Court explained that its analysis in *Mobile* under the NGA also applied to a public utility's effort to modify a contract under the FPA.[19] The Supreme Court noted, however, that a "further question" was raised in *Sierra*.[20] There, the FPC had allowed the utility's proposed rate increase to go into effect despite a contract specifying a lower rate, but had also suggested that, even if it had not concluded that the utility was permitted to file the higher rate under Section 205 of the FPA[21] (the equivalent to Section 4 of the NGA), the FPC would have found that the rate in the superseded contract was unreasonably low.[22] Relying on the FPC's statement to this effect, the public utility petitioner argued that the FPC's implementation of the proposed rate increase was justified under Section 206 of the FPA, which requires the FPC, whenever it finds a rate to be unjust and unreasonable, to establish a new just and reasonable rate to be thereafter observed.[23] In response to this argument, the Supreme Court reasoned that, while the FPC:

> may not normally *impose* upon a public utility a rate which would produce less than a fair return, it does not follow that the public utility may not itself agree by contract to a rate affording less than a fair return or that, if it does so, it is entitled to be relieved of its improvident bargain.[24]

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12. *Id*. at 339.
13. *Id*. at 342-45.
14. *Id.* at 339 (explaining that NGA section 4 is "simply a prohibition [on charging unfiled rates], not a grant of power").
15. *Id.* at 344.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Sierra*, 350 U.S. at 353.
20. *Id.*
21. 16 U.S.C. § 824d.
22. *Sierra,* 350 U.S. at 353.
23. 16 U.S.C. § 824e; *see also Sierra*, 350 U.S. at 353-55.
24. *Sierra*, 350 U.S. at 355.

In both *Mobile* and *Sierra*, the Supreme Court suggested that rates fixed by contract could be modified only "when necessary in the public interest."[25] In *Sierra*, the Court elaborated on this "public interest" analysis, explaining that where a utility unilaterally sought to increase a contract rate:

> the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest–as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory.[26]

In the decades that followed its decisions in *Mobile* and *Sierra*, there were only a handful of Supreme Court cases that discussed *Mobile* and *Sierra* in any detail, and the Court provided only limited guidance concerning how the decisions should be applied, if at all, in contexts that differed from the circumstances presented in the original *Mobile* and *Sierra* cases. The Court's decision in *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division*[27] clarified that *Mobile* did not preclude a natural gas pipeline from filing to increase a contract rate where the contract itself contemplated that the customers would pay the pipeline's "going rate" for service, as changed from time to time under the rate-changing provisions of the NGA.[28] The Court also noted in *Memphis* that contracts remain subject to the FPC's "paramount regulatory authority under [NGA] § 5(a)."[29]

In *Permian Basin Area Rate Cases*,[30] the Supreme Court addressed a number of *Mobile-Sierra* related questions. The Court upheld the FPC's adoption of area rates for natural gas sales, rejecting, *inter alia*, objections that the rate structure would understate the revenues required by producers because some producers were contractually bound to sell at prices below the maximum area rates.[31] The Court found that the FPC "permissibly declined to make adjustments in the area rates because of prevailing contract prices."[32] The Court reasoned that "[t]he regulatory system created by the [NGA] is premised on contractual agreements voluntarily devised by the regulated companies; it contemplates abrogation of those agreements only in circumstances of unequivocal public necessity."[33] The Court observed that there was "no evidence of financial or other difficulties that required the Commission to relieve producers, even obliquely, from the burdens of their contractual obligations."[34] In the same opinion, the Court affirmed the FPC's decision to modify certain price escalation clauses in producer sales contracts to the extent the clauses

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25. *Mobile*, 350 U.S. at 344; *Sierra*, 350 U.S. at 355.
26. *Sierra*, 350 U.S. at 355.
27. 358 U.S. 103 (1958).
28. *Id.* at 110; *see also id.* at 112 (explaining that:

"[t]he important and indeed decisive difference between this case and *Mobile* is that in *Mobile* one party to a contract was asserting that the Natural Gas Act somehow gave it the right unilaterally to abrogate its contractual undertaking, whereas here petitioner seeks simply to assert, in accordance with the procedures specified by the Act, rights expressly reserved to it by contract").

29. *Memphis*, 358 U.S. at 110.
30. 390 U.S. 747 (1968).
31. *Id.*
32. *Permian Basin*, 390 U.S. at 822.
33. *Id.* at 822 (citing *Mobile*, 350 U.S. at 332).
34. *Id.*

would have allowed producers to charge prices in excess of the maximum area rates found to be just and reasonable.[35] The Court explained that "[a]lthough the Natural Gas Act is premised upon a continuing system of private contracting . . . the Commission has plenary authority to limit or to proscribe contractual arrangements that contravene the relevant public interests."[36]

In *Arkansas Louisiana Gas Company v. Hall*,[37] the Supreme Court addressed the interplay between the filed rate doctrine and the rights of parties to set rates by contract. At issue was whether natural gas producers (the Hall group) that sold gas to an interstate pipeline under a contract on file with the FPC containing a "favored nations" clause could recover damages from the pipeline where it was found that the pipeline had been paying a higher price for gas to another party without notifying the Hall group.[38] The Hall group contended that the contractual favored nations clause entitled them to the higher rate, even though such higher rate had not been on file with the FPC/FERC.[39] Noting that *Permian Basin* and *Mobile* "stand only for the proposition that the Commission itself lacks affirmative authority, absent extraordinary circumstances, 'to abrogate existing contractual arrangements,'"[40] the Court rejected the Hall group's attempt to recover as contract damages the difference between the filed contract rate and the (unfiled) rate the producers purportedly would have been allowed to collect had the pipeline complied with the contractual favored nations clause. The Court observed that the producers' "theory of the case would give inordinate importance to the role of contracts between buyers and sellers in the federal scheme of regulating the sale of natural gas."[41] The Court explained in this regard that "to permit parties to vary by private agreement the rates filed with the Commission would undercut the clear purpose of the congressional scheme: granting the Commission an opportunity in every case to judge the reasonableness of the rate."[42]

The Supreme Court also discussed *Mobile* and *Sierra* in what proved to be significant dicta in *Verizon Communications, Inc. v. FCC*.[43] Contrasting the historical schemes for wholesale and retail regulation, the Court observed that "[i]n wholesale markets, the party charging the rate and the party charged were often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the

35. *Id.* at 784.

36. *Id.* at 784 (citing *Sierra*, 350 U.S. 348).

37. 453 U.S. 571 (1981).

38. *Id.* at 573.

39. *Id*.

40. *Id.* at 582 (quoting *Permian Basin,* 390 U.S. at 820).

41. *Id.*

42. *Id.* At the direction of the United States Court of Appeals for the Fifth Circuit, the FERC ultimately allowed the Hall group to collect the higher rates by granting a waiver of the thirty day notice filing requirement in Section 4(d) of the NGA. Hall v. FERC, 691 F.2d 1184 (5th Cir. 1982), *order on remand*, *Arkansas Louisiana Gas Co. v. Frank J. Hall*, 29 F.E.R.C. ¶ 61,346 (1984), *order terminating proceeding*, 31 F.E.R.C. ¶ 61,032 (1985). In remanding the case to the FERC to waive the thirty day notice requirement, however, the Fifth Circuit noted that the FERC would have the opportunity when the producers filed the higher rates to determine whether they were just and reasonable. Hall v. FERC, 691 F.2d at 1198.

43. 535 U.S. 467 (2002).

two of them."[44] This is why, the Court asserted, "Congress departed from the scheme of purely tariff-based regulation and acknowledged that contracts between commercial buyers and sellers could be used in ratesetting" under the FPA and NGA.[45] In considering wholesale contracts between commercial parties, "the principal regulatory responsibility was not to relieve a contracting party of an unreasonable rate . . . but to protect against potential discrimination by favorable contract rates between allied businesses to the detriment of other wholesale customers."[46] The Court in *Verizon* distinguished such wholesale regulation from regulation of retail transactions which "focused more on the demand for 'just and reasonable' rates to the public than on the perils of rate discrimination."[47]

Notwithstanding the relatively limited attention from the Supreme Court, the *Mobile-Sierra* "doctrine" continued to develop through the decisions of the FPC, the FERC and the U. S. Courts of Appeals.[48] Indeed, the First Circuit has observed that *Mobile* and *Sierra* "are probably among the dozen best-known public utility decisions by the Supreme Court in this century."[49] As interpreted by the FERC and the appellate courts, the "public interest" standard necessary to modify a *Mobile-Sierra* contract came to be understood as much more stringent than the statutory just and reasonable standard.[50] In his opinion in *Papago Utility Tribal Authority v. FERC*,[51] then-Judge Scalia famously characterized the *Mobile-Sierra* public interest test as "practically insurmountable" when applied in the situation where a public utility seeks unilaterally to increase a rate fixed by contract.[52]

There continued to be controversy, however, regarding whether, and to what extent, *Mobile-Sierra* applied in contexts that differed from the situation specifically at issue in the namesake decisions.[53] Disputes persisted concerning,

44. *Id.* at 479.

45. *Id.*

46. *Id.*

47. *Id.* at 480.

48. *See, e.g.*, Maine Pub. Utilities Comm'n v. FERC, 520 F.3d 464 (D.C. Cir. 2008) (hereinafter *Maine PUC II*); Maine Pub. Utilities Comm'n v. FERC, 454 F.3d 278 (D.C. Cir. 2006) (hereinafter *Maine PUC I*); Atlantic City Elec. Co. v. FERC, 295 F.3d 1 (D.C. Cir. 2002); Boston Edison Co. v. FERC, 233 F.3d 60 (1st Cir. 2000); Potomac Elec. Power Co. v. FERC, 210 F.3d 403 (D.C. Cir. 2000); Texaco, Inc. v. FERC, 148 F.3d 1091 (D.C. Cir. 1998); Union Pac. Fuels, Inc. v. FERC, 129 F.3d 157 (D.C. Cir. 1997); Northeast Utils. Serv. Co. v. FERC, 55 F.3d 686 (1st Cir. 1995); Northeast Utils. Serv. Co. v. FERC, 993 F.2d 937 (1st Cir. 1993); Tejas Power Corp. v. FERC, 908 F.2d 998 (D.C. Cir. 1990); Papago Tribal Util. Auth. v. FERC, 723 F.2d 950 (D.C. Cir. 1983); Kansas Cities v. FERC, 723 F.2d 82 (D.C. Cir. 1983); Richmond Power & Light of City of Richmond, Ind. v. FPC, 481 F.2d 490 (D.C. Cir. 1973), *cert. denied*, 414 U.S. 1068 (1973); *see also* Carmen L. Gentile, *The Mobile-Sierra Rule: Its Illustrious Past and Uncertain Future*, 21 ENERGY L.J. 353 (2006).

49. *Boston Edison*, 233 F.3d at 66.

50. *See, e.g.*, *Maine PUC II*, 520 F.3d 464; *Atlantic City Elec. Co.*, 295 F.3d at 14; *Potomac Elec. Power Co.*, 210 F.3d at 407-408.

51. 723 F.2d 950 (D.C. Cir. 1983).

52. *Id.* at 954.

53. *See, e.g.*, *Boston Edison Co.*, 233 F.3d at 67 (observing that "the cases, even within the D.C. Circuit itself, do not form a completely consistent pattern" as to when the doctrine applies); *Standard of Review for Proposed Changes to Market-Based Rate Contracts for Wholesale Sales of Electric Energy by Public Utilities*, [Proposed Regs. 1999-2003] F.E.R.C. STATS. & REGS. ¶ 32,562 (2002), *withdrawn*, 125 F.E.R.C. ¶ 61,310 (2008); Carmen L. Gentile, *The Mobile-Sierra Rule: Its Illustrious Past and Uncertain Future*, 21 ENERGY L.J. 353 (2006).

for instance, whether the FERC was required to apply a heightened "public interest" standard of review when presented with its initial opportunity to review a jurisdictional contract,[54] whether the doctrine applied where a contract rate was challenged as too high, and, if so, what factors were relevant in such a "high rate" case.[55] The Supreme Court would ultimately address some of these questions in *Morgan Stanley*.

III. THE MORGAN STANLEY DECISION

A. The Underlying FERC Proceedings

The FERC proceedings at issue in *Morgan Stanley* involved FPA Section 206 complaints filed by utilities that had entered into wholesale bilateral "forward" contracts to purchase power at market-based rates during the 2000-2001 energy crisis in the Western United States.[56] In their respective complaints, the complainants alleged that the prices or other terms in the contracts were unjust and unreasonable as a result of the crisis conditions in western power markets at the time the contracts were executed.[57]

In setting the complaints for a hearing before an administrative law judge (ALJ), the FERC found that a dispute existed as to whether the complainants were required to satisfy the heightened public interest standard under *Mobile* and *Sierra*, and a majority of the FERC opted to set this issue for hearing.[58] The FERC took as a given that the California short-term or "spot" market for electricity was dysfunctional at the time the contracts were executed, and defined the issue for hearing as "whether the dysfunctional California spot markets adversely affected the long-term bilateral markets, and, if so, whether modification of any individual contract is warranted."[59]

The ALJ assigned to hear the case concluded that the complaints must be evaluated under the *Mobile-Sierra* public interest standard, which the ALJ

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54. *Maine PUC I* , 454 F.3d 278; *Potomac Elec. Power Co.*, 210 F.3d 403; *Tejas Power Corp.*, 908 F.2d 998; Borough of Lansdale v. FPC, 494 F.2d 1104 (D.C. Cir. 1974); *Florida Power & Light Co.*, 67 F.E.R.C. ¶ 61,141 (1994); *Southern Co. Serv., Inc.*, 67 F.E.R.C. ¶ 61,080 (1994); *Northeast Utils. Serv. Co.*, 66 F.E.R.C. ¶ 61,332 (1994), *aff'd, Northeast Utilities*, 55 F.3d 686.

55. *Boston Edison*, 233 F.3d at 68-69; *Potomac Elec. Power Corp.*, 210 F.3d at 408-409; *Northeast Utilities Serv. Co.*, 55 F.3d at 690; *Northeast Utilities Serv. Co.*, 993 F.2d at 961.

56. *See, e.g., Nevada Power Co. and Sierra Pacific Power Co. v. Duke Energy Trading and Marketing, L.L.C., et al.*, 99 F.E.R.C. ¶ 61,047, *reh'g denied*, 100 F.E.R.C. ¶ 61,273 (2002). Nevada Power Company and Sierra Pacific Power Company (now NV Energy) filed complaints against ten different sellers. Public Utility District No. 1 of Snohomish County, Washington ("Snohomish") filed a complaint against Morgan Stanley Capital Group, Inc., and Southern California Water Company (now Golden State Water Company) filed a complaint against Mirant Americas Energy Marketing, L.P.

57. *Id*.

58. *Nevada Power Co. and Sierra Pacific Power Co. v. Duke Energy Trading and Marketing, L.L.C.*, *et al.*, 99 F.E.R.C. at p. 61,191 ("we will set for hearing the issue of whether the complainants must bear the burden of showing that a challenged contract is contrary to the public interest, or whether they will bear the burden of showing that the contract is not just and reasonable").

59. *Id.* FERC defined spot market sales as "sales that are 24 hours or less and that are entered into the day of or day prior to delivery." *Id.* at p. 61,191 n.15. Such spot market sales may be distinguished from longer-term sales made pursuant to bilateral "forward" contracts for power delivery executed more than a short time in advance of the sale and typically including sales over a longer period of time.

characterized as "practically insurmountable."[60] The ALJ found that under the "totality of the circumstances," none of the complainants had supported contract modification under the *Mobile-Sierra* public interest standard.[61]

By a 2-1 majority with two seats vacant, the FERC affirmed the ALJ's conclusion that the complainants were required to meet the *Mobile-Sierra* "public interest" standard of review.[62] In response to arguments that the "public interest" standard did not apply because the FERC had not previously had an opportunity to review the market-based contract rates to determine if they were just and reasonable, the FERC accepted the premise that an initial opportunity for FERC review of a contract was a prerequisite to application of the *Mobile-Sierra* public interest standard.[63] The FERC reasoned, however, that this prerequisite was satisfied by virtue of the fact that the FERC had previously authorized each of the sellers against which complaints were filed to charge market-based rates.[64]

The FERC responded to arguments that dysfunction in the markets caused by manipulation should preclude application of the *Mobile-Sierra* public interest standard by stating that there was no evidence "to support a finding that there was market manipulation *specific to* the long-term contracts at issue here,"[65] and concluded that "there is no evidence of unfairness, bad faith, or duress in the original negotiations."[66] On rehearing, the FERC indicated "that a showing of fraud, duress, or bad faith at the contract formation stage could be an alternative ground for modifying the challenged contracts," but found that the complainants had not made such a showing.[67]

Having concluded that the *Mobile-Sierra* public interest standard applied to the complaints, the FERC found that the complainants had not proven that they were entitled to relief under either the "three-prong test" from *Sierra*[68] or under the "totality of [the] circumstances."[69] Notably, the FERC concluded that a report prepared by its staff,[70] which found that market manipulation in the California spot markets had influenced forward contract prices, did not warrant granting relief because "a finding that the unjust and unreasonable spot market prices caused forward bilateral prices to be unjust and unreasonable would be

60. *Nevada Power Co. and Sierra Pacific Power Co. v. Enron Power Marketing, Inc., et al.*, 101 F.E.R.C. ¶ 63,031 at p. 65,319 (2002) (citing *Papago*, 723 F.2d 950).

61. *Id.* at pp. 65,319-25.

62. *Nevada Power Co. and Sierra Pacific Power Co. v. Enron Power Marketing, Inc., et al.*, 103 F.E.R.C. ¶ 61,353 at PP 36-41, *reh'g denied*, 105 F.E.R.C. ¶ 61,185 at PP 13-35 (2003), *remanded Public Util. Dist. No. 1 of Snohomish County, Wash. v. FERC*, 471 F.3d 1053 (9th Cir. 2006), *aff'd and remanded*, *Morgan Stanley Capital Group, Inc. v. Pub Util. Dist. No. 1 of Snohomish County, Wash.*, 128 S. Ct. 2733 (2008).

63. *Nevada Power*, 103 F.E.R.C. ¶ 61,353 at P 37; *reh'g denied*, 105 F.E.R.C. ¶ 61,185 at PP 16-17.

64. *Id.*

65. *Nevada Power*, 103 F.E.R.C. ¶ 61,353 at P 109.

66. *Id.* at P 110.

67. *Nevada Power*, 105 F.E.R.C. ¶ 61,185 at P 68.

68. The "three-prong test" refers to the Supreme Court's observation in *Sierra* that the "public interest" standard could be met where a contract rate "might [1] impair the financial ability of the public utility to continue its service, [2] cast upon other consumers an excessive burden, or [3] be unduly discriminatory." *Sierra*, 350 U.S. at 355.

69. *Nevada Power*, 103 F.E.R.C. ¶ 61,353 at PP 94-112.

70. *Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices*, Docket No. PA02-2-000, "Final Report on Price Manipulation in Western Markets" (March 2003).

relevant to contract modification only where there is a 'just and reasonable' standard of review."[71] Examining the impact that the contract rates would have on the complaining utilities' retail customers, the FERC found that the near-term rate effects, if any, did not justify contract modification under the *Mobile-Sierra* public interest standard.[72] The FERC denied the complaints, concluding that "the contracts at issue were the result of choices voluntarily made by the [c]omplainants and to the extent the [c]omplainants left themselves open to unnecessary risks, it was also their choice."[73]

B. The Ninth Circuit Decision

A number of parties filed petitions for review of the FERC's orders denying the complaints, which were consolidated in the United States Court of Appeals for the Ninth Circuit. The Ninth Circuit issued its decision on December 19, 2006, granting the petitions and remanding to FERC for further proceedings.[74]

The Ninth Circuit characterized *Mobile* and *Sierra* as standing for:

> [T]he proposition that *in certain circumstances*, a presumption applies that private parties to a wholesale electric power contract have negotiated a "just and reasonable" contract over a designated period of time, lawful under the FPA throughout that period. That presumption can be rebutted by establishing that the contract adversely affects the public interest–that is, the interests of the consuming public that the FPA protects.[75]

The Ninth Circuit rejected the FERC's suggestion that there were two separate standards for wholesale contract rates, concluding that "[t]he FPA establishes a single, albeit general, standard for FERC's adjudication of contract challenges like the present one: whether the challenged contract is 'just and reasonable.'"[76] Understood in this way, *Mobile-Sierra* establishes "presumptions regarding whether certain electricity contracts meet the statutory standard."[77]

The Ninth Circuit recognized that it was the first court to consider application of the *Mobile-Sierra* doctrine to market-based rate contracts that were not filed with the FERC, but rather were executed pursuant to market-based rate authority granted to the sellers upon a showing that they lacked market power.[78] Under a market-based pricing regime focusing on the lack of seller market power, the Ninth Circuit observed, the FERC's initial opportunity for review of rates occurs before contracts are executed, and the review does not

71. *Nevada Power*, 103 F.E.R.C. ¶ 61,353 at P 94.

72. *Id.* at PP 96-101.

73. *Id.* at P 108.

74. Public Util. Dist. No. 1 of Snohomish County, Washington v. FERC, 471 F.3d 1053 (9th Cir. 2006) ("*Snohomish*"). On the same day that the Ninth Circuit issued its decision in *Snohomish*, the Court issued a companion decision that addressed similar issues raised in an appeal brought by the California Public Utilities Commission and the California Electricity Oversight Board, Public Utils. Comm'n v. FERC, 474 F.3d 587 (9th Cir. 2006) ("*California PUC*"). The Court in *California PUC* applied the reasoning of its *Snohomish* decision to the *Mobile-Sierra* issues raised in that case. *Id.* at 591.

75. *Id.* at 1060 (footnotes omitted).

76. *Id* at 1060 n.7.

77. *Id.*

78. *Id.* at 1060-61.

focus on the terms of individual contracts.[79] These factual differences from *Mobile* and *Sierra*, the Ninth Circuit noted, did not "render *Mobile-Sierra* a dead letter,"[80] but the evolution of the FERC's rate review approach "reinforces the need to delineate carefully the prerequisites for its application in the present environment."[81]

The Ninth Circuit identified three prerequisites for establishing the *Mobile-Sierra* presumption of justness and reasonableness. First, "the contract by its own terms must not preclude the limited *Mobile-Sierra* review."[82] Second, the Ninth Circuit reasoned that "the regulatory scheme in which the contracts are formed must provide FERC with an opportunity for effective, timely review of the contracted rates."[83] Third, if the FERC is relying on market-based pricing, the timely review of rates "must permit consideration of all factors relevant to the propriety of the contract's formation."[84] "In the present regulatory regime," the Ninth Circuit explained, the "relevant factors focus on whether the original negotiations occurred in a functional marketplace such that we may presume the contracted rates were originally just and reasonable."[85] The Ninth Circuit derived these three prerequisites "from the context of *Mobile-Sierra* and from later cases employing the doctrine."[86] Where these three prerequisites were satisfied, the Ninth Circuit held, a presumption applies "that parties have negotiated a contract that is just and reasonable between them."[87]

Applying these three prerequisites to the facts of the case, the Ninth Circuit found that the FERC had not justified its application of the *Mobile-Sierra* presumption of justness and reasonableness to the challenged contracts.[88] Although the Ninth Circuit concluded that a grant of market-based rate authority "*can* qualify as sufficient prior review to justify limited *Mobile-Sierra* review,"[89] such a predetermination of justness and reasonableness must be "accompanied by effective oversight permitting timely reconsideration of market-based authorization if market conditions change."[90] The Ninth Circuit found that the FERC's market oversight during the western energy crisis had been inadequate to satisfy the *Mobile-Sierra* prerequisites, explaining that "the fatal flaw in FERC's approach to 'oversight' is that it precludes timely consideration of market changes and offers no protection to purchasers victimized by the abuses of sellers or dysfunctional market conditions that FERC itself only notices in hindsight."[91]

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79. *Id*. at 1061.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.* at 1077.

86. *Id.* at 1075.

87. *Id.* at 1061.

88. The Court agreed that the contracts did not expressly preclude application of the *Mobile-Sierra* presumption. *See generally Snohomish*, 471 F.3d at 1078-79.

89. *Id.* at 1080.

90. *Id.*

91. *Id.* at 1085. The Court found fault, in particular, with the FERC's conclusion that the FERC Staff Report was irrelevant to its analysis. The Court believed that the Staff's findings concerning the relationship

Although the Ninth Circuit concluded that the FERC had not justified its application of the *Mobile-Sierra* public interest standard, it went further, finding that, even if the *Mobile-Sierra* presumption of justness and reasonableness was applicable, the FERC had used "an erroneous standard for determining whether the challenged contracts affect the public interest."[92] The Ninth Circuit noted that *Mobile* and *Sierra* both involved proposals to change rates that the filing utility considered too low, whereas this case involved allegations that the contract rates were too high.[93] In this respect, the FERC erred by "applying factors taken from the context of a *low-rate* challenge rather than those relevant to the *high-rate* challenge present in this case."[94] The Ninth Circuit reasoned that the "FERC must give predominant weight in determining whether to modify a contract under section 206 [of the FPA] to the impact of a challenged wholesale contract on the rates paid by the consuming public who use the energy covered by the contract."[95] While acknowledging that "stability of contract considerations that underlie the *Mobile-Sierra* doctrine do carry over to challenges by buyers rather than sellers,"[96] the Ninth Circuit found that such considerations "do not justify the abnegation of FERC's statutory responsibility to protect the public from unjustifiably high rates in wholesale contracts."[97] The FERC is required, the Ninth Circuit reasoned, to "take into account the Supreme Court's admonition that even 'a small dent in the consumer's pocket' is relevant to the determination of fair rates."[98]

The Ninth Circuit concluded:

> In the context of a high-rate challenge, consequently, a high-rate public interest determination should focus on whether consumers' electricity bills have been affected by the challenged rates–not necessarily whether the electricity bills have increased since the signing of the contracts, but whether those bills are higher than they would otherwise have been had the challenged contracts called for rates within the just and reasonable range.[99]

Examining the FERC's public interest analysis of each of the complaints, the Ninth Circuit found the FERC's reasoning to be deficient. The Ninth Circuit rejected the FERC's analysis insofar as it focused too heavily on near-term rate

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between spot and forward prices were "relevant to determining whether the *Mobile-Sierra* doctrine applies, because they raise questions about the market conditions at the time of contract formation and thus about the propriety of relying on a regime of market-based rate authority at that time to produce just and reasonable rates." *Id.* at 1087.

92. *Id.* at 1087.

93. *Id*. at 1060.

94. *Id*. at 1087.

95. *Id.* at 1087-88.

96. *Id.* at 1089.

97. *Id.*

98. *Id.* (quoting Federal Power Comm'n v. Texaco, Inc., 417 U.S. 380, 399 (1974)).

99. *Snohomish*, 471 F.3d at 1089. The Court noted that it did not mean "that *any* direct impact on consumer rates is enough to demonstrate a public interest effect sufficient to displace the countervailing *Mobile-Sierra* concern with protecting the stability of contract." *Id.* Market-based pricing presumes that market forces will drive prices towards marginal cost over time, thus, "[e]ven if a particular rate exceeds marginal cost . . . it may still be within this reasonable range–or zone of reasonableness–if that higher-than-cost-based price results from normal market forces and is part of a general trend toward rates that do reflect cost." *Id.*

impacts from the contracts, rather than on whether complainants' customers would pay higher rates than they would have without the challenged contracts.[100]

The Ninth Circuit remanded "so that FERC can apply the proper statutory standards to determine, first, whether *Mobile-Sierra* review of the challenged contracts is appropriate; second, if so, to apply the modified form of *Mobile-Sierra* review outlined in this opinion; and finally, if not, to apply full just and reasonable review to the challenged contracts."[101]

A number of petitions for writs of certiorari to the Ninth Circuit regarding the *Snohomish* and companion *California PUC* rulings were filed. Over the FERC's opposition,[102] the Supreme Court granted certiorari.

C. The Supreme Court's Ruling

On June 26, 2008, the last day of the 2007 term, the Supreme Court issued its decision in *Morgan Stanley*. In a 5-2 decision with Chief Justice Roberts and Justice Breyer not participating, the Court affirmed the judgment of the Ninth Circuit but disagreed with much of the appellate court's reasoning. Four justices–Alito, Kennedy, Scalia, and Thomas–joined in the entirety of the majority opinion. Justice Ginsburg joined only the portion of the majority opinion that found a remand was required on several issues. Justice Stevens, joined by Justice Souter, dissented.

Justice Scalia, delivering the decision for the Court, explained in the opening sentence of the opinion that "[u]nder the *Mobile-Sierra* doctrine, [the FERC] must presume that the rate set out in a freely negotiated wholesale-energy contract meets the 'just and reasonable' requirement imposed by law."[103] This presumption, the Court stated, "may be overcome only if FERC concludes that the contract seriously harms the public interest."[104] Having stated these principles, the Court identified two basic questions presented concerning the scope of the *Mobile-Sierra* doctrine:

1. "[D]oes the presumption [of justness and reasonableness] apply only when FERC has had an initial opportunity to review a contract rate without the presumption?"[105]
2. "[D]oes the presumption impose as high a bar to challenges by purchasers of wholesale electricity as it does to challenges by sellers?"[106]

The Court concluded that an initial opportunity for FERC review of a contract is not a prerequisite for applying the *Mobile-Sierra* presumption of justness and reasonableness. As to the second question, the Court explained that

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100. *Snohomish*, 471 F.3d at 1090.

101. *Id.*

102. *See generally Sempra Generation, et al. v. Public Utilities Comm'n of the State of Cal.*, Nos. 06-1454, 06-1457, 06-1462, and 06-1468, "Brief for the Federal Energy Regulatory Commission in Opposition" (U.S. Supreme Court August 2007).

103. *Morgan Stanley*, 128 S. Ct. at 2737.

104. *Id.*.

105. *Id.*

106. *Id.*

the standard to reform a contract in a "high rate" case is generally the same as in a "low rate" case, although, as discussed below, the question remains whether the standard for a successful high rate challenge is "practically insurmountable." In addressing the two questions above, the Court also discussed a number of other aspects of the *Mobile-Sierra* doctrine, particularly as it applies to contracts under the FERC's market-based rate regime for wholesale electric contracts.

Although affirming the Ninth Circuit's judgment, the Supreme Court generally rejected the prerequisites the Court of Appeals had placed upon application of the *Mobile-Sierra* presumption that wholesale contract rates are just and reasonable.[107] Further, the Supreme Court disagreed with the Ninth Circuit's characterization of the analysis to be applied in evaluating whether the public interest test is met in a "high rate" case.[108]

Notably, although the case involved contracts executed under the FERC's market-based rate program for electricity sales, the Court specified that it was not addressing "the lawfulness of the [FERC's] market-based-tariff system."[109] Observing that, though the FERC's market-based rate scheme "assuredly has its critics,"[110] the Court found that "any needed revision in that scheme is properly addressed in a challenge to the scheme itself, not through a disfigurement of the venerable *Mobile-Sierra* doctrine."[111]

1. A Single Statutory Standard Of Review

While it rejected much of the Ninth Circuit's analysis of the *Mobile-Sierra* doctrine, the Supreme Court was in "broad agreement" that there is only one statutory standard.[112] The standard for assessing wholesale electricity rates, whether set by contract or tariff, is the just and reasonable standard.[113] The Court observed that the FERC had begun to refer to the two modes of review as the "public interest standard" and the "just and reasonable standard,"[114] but reasoned that use of this "nomenclature" did not stand for the "obviously indefensible proposition" that a standard different from the statutory just and reasonable standard applies to contract rates.[115] Instead, the term "public interest standard" refers to the *differing application* of the "just and reasonable" standard to contract rates.[116]

In a footnote responding to the dissent's arguments that there was no meaningful distinction between characterizing the *Mobile-Sierra* public interest standard as a differing application of the just and reasonable standard and calling it a different standard altogether, and that the FPA did not in any case provide for a differing application of the just and reasonable standard for contracts,[117] the

107. *Id*. at 2748-2749.
108. *Id*.
109. *Id.* at 2741; *Id.* at 2747.
110. *Id.* at 2747.
111. *Id.*
112. *Id*. at 2745.
113. *Id*.
114. *Id.* at 2740.
115. *Id.*
116. *Id.*
117. *Id*. at 2752 (Stevens, J., dissenting).

majority invoked *stare decisis* principles. The Court maintained that "the dissent's interpretation, whatever plausibility it has as an original matter, cannot be squared with *Sierra*, which plainly distinguished between unilaterally and bilaterally set rates, and said that the only relevant consideration for the Commission in the latter case is whether the public interest is harmed."[118] The dissent, the Court asserted, "simply argues against the settled understanding of the FPA that has prevailed in this Court, lower courts, and the Commission for half a century."[119] The majority concluded its rejoinder to Justice Stevens with the observation that "[i]f there were ever a context where long-settled understanding should be honored it is here, when a *statutory* decision (subject to revision by Congress) has been understood the same way for many years by lower courts, by this Court, by the federal agency the statute governs, and hence surely by the private actors trying to observe the law."[120]

2. Application Of The *Mobile-Sierra* Presumption Is The Default Rule

In describing the *Mobile-Sierra* doctrine, the Court explained that its previous decisions, and the decisions of the courts of appeals had "refined the *Mobile-Sierra* presumption to allow greater freedom of contract."[121] Citing *Memphis*, the Court noted that parties can "contract out of the *Mobile-Sierra* presumption by specifying in their contracts that a new rate filed with the Commission would supersede the contract rate."[122] Parties may also choose a "middle option" in which the contract does not permit the seller to file a new rate but allows the FERC "to set aside the contract rate if it results in an unfair rate of return, not just if it violates the public interest."[123] While noting this "freedom of contract" to opt out of the application of *Mobile-Sierra*, the Court stated that "the *Mobile-Sierra* presumption remains the default rule."[124]

3. An Initial Opportunity For FERC Review Of The Contract Is Not Required For The *Mobile-Sierra* Public Interest Mode Of Review To Apply

The Court in *Morgan Stanley* rejected the position that the FERC must have an initial opportunity to review a contract before the *Mobile-Sierra* presumption applies.[125] Locating the basis of the *Mobile-Sierra* presumption in the fact that the FERC had had an initial chance to pass on the rate, the Ninth Circuit explained that, once the FERC had its opportunity for just and reasonable review, "there would be a presumption–based on both the need to protect stability of contract and the likelihood that market participants entering into long-term contracts can protect their own interests–that the reasonableness continued throughout the term of the contract."[126]

118. *Id*. at 2749 n.6.

119. *Id*.

120. *Id.*

121. *Id.* at 2739.

122. *Id.* (citing *Memphis*, 358 U.S. at 110-113).

123. *Id.* (citing *Papago*, 720 F.2d at 953; Louisiana Power & Light Co. v. FERC, 587 F.2d 671, 675-76 (5th Cir. 1979)).

124. *Id.*

125. *Id*. at 2745-46.

126. *Snohomish*, 471 F.3d at 1077.

The Supreme Court rejected the Ninth Circuit's analysis, calling it "a misreading of *Sierra*."[127] The Court characterized the Ninth Circuit's view of *Mobile-Sierra* as "the equivalent of an estoppel doctrine" where an initial FERC opportunity for review serves as the ground for precluding future modification of the rate absent serious harm to the public interest.[128] According to the Supreme Court, however, "*Sierra* said nothing of the sort."[129] Instead, the Court cited its dicta from *Verizon* for the proposition that *Sierra* was based upon the "commonsense notion" that the parties to a wholesale contract typically are sophisticated businesses enjoying presumptively equal bargaining power so they can be expected to negotiate a just and reasonable rate as between them.[130] "[O]nly when the mutually agreed-upon contract rate seriously harms the consuming public" will it not be just and reasonable.[131] The Court disagreed with the Ninth Circuit's interpretation of *Sierra* as requiring the FERC to apply the just and reasonable standard differently depending on *when* a contract rate is challenged.[132] The definition provided in *Sierra* of what it means for a rate to satisfy the just and reasonable standard in the contract context, the Court explained, applies regardless of when the contract is reviewed.[133]

In holding that application of the *Mobile-Sierra* presumption of justness and reasonableness does not require an initial opportunity for review by the FERC, the Court noted that the FERC had "change[d] its tune" on this question in its merits brief to the Court insofar as the FERC took the position–contrary to its orders below–that such an opportunity for FERC review was not necessary for *Mobile-Sierra* to apply.[134] Notwithstanding the FERC's abandonment of its previous position, the Supreme Court rejected arguments that it must remand under *SEC v. Chenery Corporation*[135] because the FERC purported to defend its order on a basis different than the rationale articulated below.[136] The Court declined to remand on these grounds because, in its view, the FERC was "required" to apply the *Mobile-Sierra* presumption in its evaluation of the contracts regardless of whether the FERC had an initial opportunity to review them.[137] Remanding the case because the FERC had provided a different rationale for a "necessary result" would be "an idle and useless formality."[138]

127. *Morgan Stanley*, 128 S. Ct. at 2746.

128. *Id.* (quoting Tewksbury & Kim, *Applying the Mobile-Sierra Doctrine to Market-Based Rate Contracts*, 26 ENERGY L.J. 437, 457-58 (2005)).

129. *Morgan Stanley*,128 S. Ct. at 2746.

130. *Id.* (quoting *Verizon*, 535 U.S. at 479).

131. *Morgan Stanley*, 128 S. Ct. 2746.

132. *Id.* at 2745.

133. The Court observed that it would be "odd" to base curtailment of later contract challenges upon the FERC having an initial opportunity for review given that the FERC's "passive permission for a rate to go into effect does not constitute a finding that the rate is just and reasonable." *Id*. at 2746.

134. *Id.* at 2745.

135. SEC v. Chenery Corporation, 318 U.S. 80 (1943). Under *Chenery*, the Court will not uphold a discretionary agency decision where the agency has offered a justification in court different from what it provided in its decision. *See also Morgan Stanley*, 128 S. Ct. 2745.

136. *Morgan Stanley*, 128 S. Ct. 2745.

137. *Id*.

138. *Id.* at 2745.

4. General Market Dysfunction Does Not Prevent Application Of The *Mobile-Sierra* Presumption

The Supreme Court also disagreed with the Ninth Circuit's conclusion that the FERC must inquire into whether a contract was formed in an environment of market "dysfunction" before applying the *Mobile-Sierra* presumption.[139] The Court observed that "[m]arkets are not perfect, and one of the reasons that parties enter into wholesale-power contracts is precisely to hedge against the volatility that market imperfections produce."[140] It would be a "perverse rule," the Court opined, that rendered such contracts less likely to be enforced when there is volatility in the market.[141]

The Ninth Circuit's holding, the Supreme Court observed, would allow sophisticated parties to renounce long-term contracts entered into to weather market turmoil once that turmoil had subsided, a result which "would reduce the incentive to conclude such contracts in the future."[142] Not only did the Ninth Circuit's conclusion lack support in the case law, it would undermine the role of contracts in the FPA's statutory scheme.[143] The Court emphasized that "the mere fact that the market is imperfect, or even chaotic, is no reason to undermine the stabilizing force of contracts that the FPA embraced as an alternative to 'purely tariff-based regulation.'"[144]

The Court did place some caveats on its conclusion that the default *Mobile-Sierra* presumption should apply to market-based rate contracts even where the market was alleged to have been "dysfunctional" at the time the contract was executed. First, the Court explained that a contract rate should not be presumed to be just and reasonable pursuant to *Mobile-Sierra* "if the 'dysfunctional' market conditions under which the contract was formed were caused by illegal action of one of the parties."[145] The Court also indicated that the presumption would not apply where the FERC finds "unfair dealing at the contract formation stage–for instance, if [the FERC] finds traditional grounds for the abrogation of the contract such as fraud or duress."[146] Further, the Court suggested in a footnote that, even if the *Mobile-Sierra* presumption of justness and reasonableness applies, the existence of market dysfunction at the time of contracting would be relevant to the analysis of whether the contracts impose an "excessive burden" on consumers that would warrant reformation of the contract.[147]

139. *Id.* at 2746. The Court commented that "evaluating market 'dysfunction' is a very difficult and highly speculative task–not one that the FPA would likely require the agency to engage in before holding sophisticated parties to their bargains." *Id.* at 2747.

140. *Id.* at 2746.

141. *Id.*

142. *Id.* at 2747.

143. *Id.*

144. *Id.* (quoting *Verizon*, 535 U.S. at 479).

145. *Id*. at 2747.

146. *Id*.

147. *Id.* at 2748 n.4; *Id.* at 2750.

5. Rejection Of The Ninth Circuit's "Zone Of Reasonableness" Standard For A "High Rate" Challenge

The Supreme Court also overturned the Ninth Circuit's holding that even where the *Mobile-Sierra* presumption applies, a contract should be reformed if the wholesale rate "is outside the 'zone of reasonableness' and results in retail rates higher than would be the case if that zone were not exceeded."[148] The Supreme Court clarified that "[t]he standard for a buyer's challenge must be the same, generally speaking, as the standard for a seller's challenge: The contract rate must seriously harm the public interest."[149]

The Court prefaced its discussion of this issue by noting its agreement with the Ninth Circuit that the three public interest factors identified in *Sierra* "are not all precisely applicable to the high-rate challenge of a purchaser."[150] Further, the three *Sierra* factors "are in any event not the exclusive components of the public interest."[151] The Supreme Court nonetheless suggested that *Sierra's* "excessive burden" factor[152] remained a valid consideration in the public interest analysis except that the relevant question in a "high-rate" case is whether the *customers of the wholesale purchaser* would be excessively burdened absent contract modification.[153]

The Court found that the Ninth Circuit misread the *Sierra* "excessive burden" factor to mean merely the burden caused when one set of consumers (either other wholesale customers or retail customers of a purchaser) is forced to pay above marginal cost under the contract to compensate for below-marginal-cost rates for other customers.[154] This formulation–where the presumption of validity disappears when the rate is above marginal cost–would be a "reinstitution of cost-based rather than contract-based regulation."[155] The majority found that the "mere exceeding of marginal cost" does not amount to "unequivocal public necessity" or "extraordinary circumstances" that permit setting aside a contract rate under *Mobile-Sierra*.[156] Instead, under the FPA, the FERC's contract abrogation power is reserved for "those extraordinary circumstances where the public will be severely harmed."[157]

148. *Snohomish*, 471 F.3d at 1089.

149. *Morgan Stanley*, 128 S. Ct. at 2747. The Court noted that even though the challenges in *Mobile* and *Sierra* were brought by sellers, lower courts have subsequently concluded that the *Mobile-Sierra* presumption also applies where a purchaser, rather than a seller, asks the FERC to modify a contract. *Id.* at 2739. The Court observed in this regard that it had "seemingly blessed" that conclusion in *Verizon* in stating that "[w]hen commercial parties . . . avail themselves of rate agreements, the principal regulatory responsibility [is] not to relieve a contracting party of an unreasonable rate." *Id.* at 2739-40 (quoting *Verizon*, 535 U.S. at 479).

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

151. *Id.*

152. *Sierra*, 350 U.S. at 355 (explaining that a rate might be contrary to the public interest where it would "cast upon other consumers an excessive burden").

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

154. *Id.* at 2748.

155. *Id.*

156. *Id.* at 2748-49. The Court observed that besides being wrong in principle, the Ninth Circuit's rule would impose enormous regulatory costs on the FERC because it would need to calculate the marginal cost of power sold under a market-based contract. *Id.* at 2749.

157. *Id.* at 2749.

The Court reasoned that the Ninth Circuit's formulation of the standard required to modify a wholesale power contract failed to accord an adequate level of protection to contracts, which "would threaten to inject more volatility into the electricity market by undermining a key source of stability."[158] The Court posited in this regard that the FPA had recognized that "contract stability ultimately benefits consumers, even if short-term rates for a subset of the public might be high by historical standards."[159]

6. Remanded Issues

Although the Supreme Court disagreed with much of the Ninth Circuit's reasoning, it ultimately affirmed the judgment of the Court of Appeals, finding two deficiencies in the FERC's orders that required a remand.

First, the Court concluded that the FERC's analysis was flawed—or at least incomplete—as to whether the challenged contracts imposed an "excessive burden" on consumers.[160] The FERC erred, the Court found, to the extent that it applied the *Sierra* "excessive burden" factor by looking simply at whether consumers' rates increased immediately upon the relevant contracts going into effect.[161] Instead, the FERC should have determined whether the contracts imposed an excessive burden on consumers "down the line."[162] *Sierra's* "excessive burden" on other customers was the current burden, not just the burden imposed at the outset of the contract,[163] and the "unequivocal public necessity" that justifies overriding the *Mobile-Sierra* presumption does not disappear as a factor once the contract enters into force.[164]

In assessing the burden on consumers "down the line" in this case, the Court explained that the FERC should look at "the disparity between the contract rate and the rate consumers would have paid (but for the contracts) further down the line, when the open market was no longer dysfunctional."[165] And, if that disparity is so great that the rates impose an excessive burden on consumers or otherwise seriously harm the public interest, even after taking into account the desirability of fostering market-stabilizing long-term contracts, "the rates must be disallowed."[166]

As described above, the Court explained that the *Mobile-Sierra* presumption of justness and reasonableness should not apply at all where a contract was executed in a dysfunctional market and the illegal activities of one of the parties contributed to the dysfunction in a manner that affected the contract. The Court found a remand was also necessary on this issue because it was unable to determine from the FERC's orders whether the Commission had found the record inadequate to support the buyers' claims that the sellers' alleged

158. *Id.*
159. *Id.*
160. *Id*. at 2750.
161. *Id.* at 2749-50.
162. *Id.* at 2750.
163. *Id.*
164. *Id.*
165. *Id*.
166. *Id.*

unlawful activities affected the challenged contracts.[167] The Court reiterated that, like fraud and duress, unlawful market activity that directly affects contract negotiations eliminates the premise on which the *Mobile-Sierra* presumption rests–that the contract rates are the product of fair, arms-length negotiations.[168] The Court cautioned that the mere fact that the unlawful activity may have happened in a different, but related market (i.e., the spot market) does not automatically establish that it had no effect upon forward contract rates.[169] By the same token, the mere fact of a party's engaging in unlawful activity in the spot market does not, by itself, deprive the party's forward contracts of the *Mobile-Sierra* presumption.[170] Where causality is established between the unlawful activity and the contract rate, however, the *Mobile-Sierra* presumption should not apply.[171]

7. The Dissent

In his dissent, Justice Stevens broadly disputed the majority's conclusions regarding the operation of the *Mobile-Sierra* doctrine. Indeed, Justice Stevens questioned the notion that there was even such a thing as the "*Mobile-Sierra* doctrine."[172]

The dissent asserted that the Court, lacking any grounding in the FPA or precedent for its ruling, had simply relied on its own policy judgment that the *Mobile-Sierra* presumption is necessary to ensure stability in volatile energy markets and to reduce regulatory costs.[173] While acknowledging that fostering market-stabilizing long-term contracts "plays into the public interest insofar as the 'Commission's responsibilities include the protection of future, as well as present, consumer interests,'"[174] Justice Stevens suggested that such balancing is left to the FERC, not the Court, under the FPA.[175] The dissent concluded, however, that not even the FERC, let alone the Court, has the authority to adopt a "practically insurmountable" presumption that all rates set by contract are just and reasonable.[176]

The dissent concluded by returning to the Court's suggestion that the FERC "lucked out" by avoiding a *Chenery* remand because of the Court's conclusion that the FERC was required to apply a presumption of justness and reasonableness.[177] The dissent characterizes the FERC's alleged good fortune as "not only a purely fortuitous victory, but also a Pyrrhic one."[178] While the FERC seems to prevail in this case, Justice Stevens argued, it has paid a "tremendous

167. *Id.* at 2750.
168. *Id.*
169. *Id*.
170. *Id.* at 2751.
171. *Id.*
172. *Morgan Stanley*, 128 S. Ct. at 2751 (Stevens, J., dissenting) (observing that the term "Mobile-Sierra doctrine" was making "[i]ts first appearance in the United States Reports today").
173. *Id.* at 2756.
174. *Id.* (quoting *Permian Basin*, 390 U.S. at 798).
175. *Id.*
176. *Id.*
177. *Id*. at 2759.
178. *Id.*

price" because "[t]he Court has curtailed the agency's authority to interpret the terms 'just and reasonable' and thereby substantially narrowed FERC's discretion to protect the public interest by the means it thinks best."[179] The dissent argued that the FERC would no longer have "the flexibility to adjust its review of contractual rates to account for changing conditions in the energy markets or among consumers."[180] While the dissent said that the Ninth Circuit "deserves praise for its efforts to bring the freewheeling *Mobile-Sierra* doctrine back in line with the FPA and this Court's cases,"[181] the dissent would have vacated and remanded the Ninth Circuit opinion because it too was overly prescriptive regarding the contract review the FERC must perform.[182] Justice Stevens would have remanded to the FERC to give it "an opportunity to evaluate the contract rates in light of a proper understanding of its discretion."[183]

IV. THE *MOBILE-SIERRA* DOCTRINE AFTER *MORGAN STANLEY*: SOME ANSWERS, MANY QUESTIONS

When the Supreme Court, after fifty-two years, revisited its *Mobile* and *Sierra* decisions in *Morgan Stanley*, it answered some lingering questions about the application of the *Mobile-Sierra* doctrine outside the context in which the eponymous Supreme Court cases were originally decided.[184] At the most basic level, the Court clarified that the *Mobile-Sierra* public interest standard is not to be regarded as distinct from the statutory just and reasonable standard of review, but rather, is a different way of applying the just and reasonable standard to contracts.[185] The Court also explained that the *Mobile-Sierra* presumption is the "default rule" to be applied unless the contracting parties provide otherwise in the contract.[186]

The Court clarified, moreover, that application of the *Mobile-Sierra* presumption of justness and reasonableness is not dependent upon the FERC having an "initial opportunity" to review a contract.[187] The basis for the presumption, the Court explained, is not prior FERC approval or acceptance of the rate, but the notion that "sophisticated businesses enjoying presumptively equal bargaining power . . . could be expected to negotiate a 'just and reasonable' rate as between the two of them."[188]

Important from the standpoint of the FERC's reliance on market-based pricing for electricity sales, this presumption of justness and reasonableness extends to contracts executed pursuant to blanket market-based rate authority. Further, the presumption applies even to market-based contracts executed in a "dysfunctional" market, provided the dysfunctional market conditions were not

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id*.

183. *Id.*

184. *Morgan Stanley*, 128 S. Ct. 2733.

185. *Id*. at 2745-46.

186. *Id.* at 2739; *see also Standard of Review for Proposed Changes to Market-Based Rate Contracts for Wholesale Sales of Electric Energy by Public Utilities*, 125 F.E.R.C. ¶ 61,310 (2008).

187. *Morgan Stanley*, 128 S. Ct. at 2746.

188. *Id.* (quoting *Verizon*, 543 U.S. at 479).

"caused by illegal action of one of the parties."[189] Although the Court pointedly observed that it was not addressing "the lawfulness of the [FERC's] market-based-tariff system,"[190] assuming, *arguendo*, that the FERC's program is not otherwise overturned, the Court's rulings in *Morgan Stanley* make it less likely that market-based contracts may be successfully challenged. In particular, the ruling appears to foreclose the argument–accepted by the Ninth Circuit–that applying an *ex ante* presumption that market-based contract rates are just and reasonable is not necessarily consistent with the FERC's ongoing responsibility to oversee competitive wholesale electricity markets to ensure that they produce just and reasonable rates.[191]

In response to arguments that a "public interest" test necessarily must be more flexible in a "high rate" case than the "low rate" situation presented in the original *Mobile* and *Sierra* cases, the Supreme Court explained that, generally speaking, the standard in both cases is the same, i.e., "[t]he contract rate must seriously harm the public interest."[192] Although, as described below, the Court's remand leaves open the question whether *Mobile-Sierra* imposes a "practically insurmountable" burden in "high rate" cases.

While *Morgan Stanley* clarifies a number of issues concerning application of the *Mobile-Sierra* doctrine–particularly as to market-based electric rates–the decision leaves numerous unanswered questions. The FERC and the courts likely will have to grapple with these issues for years to come. Some of these issues are discussed below.

A. Potential Implications Of The Court's Ruling That There Is No Initial Opportunity For Review

The most significant aspect of the *Morgan Stanley* decision ultimately may prove to be the Court's rejection of the view that the *Mobile-Sierra* "public interest" mode of contract review only applies where the FERC has had an initial opportunity to review the contract in question without applying the *Mobile-Sierra* presumption. The decision is significant because the FERC generally took the position–until its merits brief to the Supreme Court in *Morgan Stanley*–that it was *not* required to apply a public interest standard of review in its initial review of a contract,[193] and this position had support in decisions of the courts of appeals,[194] and the Supreme Court itself.[195]

189. *Id.* at 2747.

190. *Id.* at 2741.

191. *Snohomish*, 471 F.3d at 1080-81.

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

193. *See, e.g.*, *Morgan Stanley*, 128 S. Ct. at 2745; *Nevada Power*, 105 F.E.R.C. ¶ 61,185 at P 16-17; *Southern Co. Serv., Inc.*, 67 F.E.R.C. ¶ 61,080 at p. 61,227 (1994) (explaining that "parties can never bind the Commission to a public interest standard of review of a contract which the Commission previously has not had the opportunity to review and act upon"); *Florida Power & Light Co.*, 67 F.E.R.C. ¶ 61,141 at p. 61,396-97 (1994); *see also Maine Pub. Utilities Comm'n v. FERC*, No. 06-1403, Dissent of Commissioners Kelly and Wellinghoff from decision to request rehearing at 2-3 (D.C. Cir. August 4, 2008) (observing that *Morgan Stanley*'s holding on the issue of the opportunity for initial FERC review "is different from the Commission's previous understanding of the law, which it believed required the Commission initially to review a contract under the 'ordinary' just and reasonable standard, *i.e.*, without a *Mobile-Sierra* presumption").

194. *See, e.g.*, *Maine PUC I*, 454 F.3d at 283-286; Pennsylvania Elec. Co. v. FERC, 11 F.3d 207, 210 (D.C. Cir. 1993); *Tejas Power Corp.*, 908 F.2d at 1003.

Even in cases where the FERC has viewed itself as under an obligation to apply a *Mobile-Sierra* form of review in its initial review of a contract, the FERC asserted that its initial review was subject to a more flexible version of the public interest analysis than the "practically insurmountable" standard that had been derived from *Sierra*.[196] The FERC asserted that employing a "practically insurmountable" public interest standard in its initial review of a contract would mean that "public regulation would consist of little more than rubber-stamping private contracts."[197] By clarifying that the *Mobile-Sierra* presumption of justness and reasonableness is not dependent on the FERC having an initial opportunity to review the contract without the presumption, *Morgan Stanley* raises numerous questions concerning the scope of the FERC's authority to reject or modify contracts under *Mobile-Sierra*.[198]

1. Rejection Of Contract Terms Inconsistent With FERC Policies Or Regulations

One general question involves the effect of *Morgan Stanley* on the FERC's authority to reject contractual rates, terms and conditions that are inconsistent with the Commission's regulatory policies, or even its regulations. In *Northeast Utilities*, the FERC expressed concern that application of a "practically insurmountable" *Mobile-Sierra* public interest standard when a contract is initially filed would reduce the FERC's role to "rubber-stamping private contracts."[199] The Supreme Court's clarification that no initial opportunity for review is required before the *Mobile-Sierra* presumption applies, especially when read in conjunction with the Court's statement that the standard for contract reformation is generally the same in both high and low rate cases, could prompt arguments that the FERC may not reject a contract that does not comply with FERC policies or regulations absent a finding that "the contract seriously harms the public interest."[200] After all, the basic statutory requirement for most rates, terms and conditions of service under both the FPA and the NGA is simply that they must be just and reasonable and non-discriminatory. By and large, the FERC's policies and regulations under the FPA and the NGA are but the means to implement the FERC's view of how best to satisfy the just and reasonable and non-discrimination standards. But if a contract rate, term or condition is presumptively just and reasonable subject only to modification based on a showing of serious harm to the public interest, one could argue that the contract

195. *Arkansas Louisiana*, 453 U.S. at 582 (explaining that the purpose of the rate filing requirement of the FPA and NGA is to "grant[] the Commission an opportunity in every case to judge the reasonableness of the rate"). But, *see also* Tewksbury & Kim, *Applying the Mobile-Sierra Doctrine to Market–Based Rate Contracts*, 26 ENERGY L.J. 437, 458-66 (2005) (arguing that initial FERC review of a contract was not a prerequisite to applying a public interest mode of review under *Mobile-Sierra*).

196. *See generally Northeast Utilities Serv. Co.*, 66 F.E.R.C. ¶ 61,332, 62,087-88 (1994), *aff'd Northeast Utilities*, 55 F.3d 686. Although the FERC purported to apply the "public interest" standard, albeit a more flexible version of it, in *Northeast Utilities*, the FERC later suggested that the case stood for the proposition that the public interest standard did not apply at all to initial contract review. *See also Southern Co. Serv., Inc.*, 67 F.E.R.C. at ¶ 61,080, 61,227 (1994).

197. *Northeast Utilities*, 66 F.E.R.C. at p. 62,087.

198. *Morgan Stanley*, 128 S. Ct. at 2735.

199. *Northeast Utilities*, 66 F.E.R.C. at p. 62,087.

200. *Morgan Stanley*, 128 S. Ct. at 2737.

need not conform to *the FERC's* view of the best way to implement a just and reasonable rate, term or condition.[201]

It may be that the FERC would be able to successfully take the position that any contract filed with the agency that is inconsistent with its regulations or policies necessarily contravenes the public interest and will be rejected absent a waiver. The FERC has long had the authority to reject filings outright where they reflected terms that depart from the FERC's regulations and policies.[202] This authority would serve as a counterweight to arguments that *Morgan Stanley* obligates the FERC to accept as just and reasonable wholesale contracts negotiated by private parties, regardless of whether the contract terms comply with the Commission's policies.

The chance may also be small that parties will file contracts that propose material departures from clearly-defined FERC rules or policies and claim that such variations are immune from FERC modification absent a finding that the contract seriously harms the public interest. Taking such a position would seem to be a recipe for the contractual and regulatory uncertainty that the *Mobile-Sierra* doctrine is intended to prevent.

Nonetheless, it is likely that, by definition, the scope of the FERC's authority will be tested when contract provisions are controversial and/or where FERC policy or rules are not clearly defined. Thus, the Supreme Court's ruling could restrict the FERC's discretion precisely when it needs it most–when it wishes to impose policy in a case where parties have contractually provided otherwise.

2. Contract Challenges By Third Parties

The Supreme Court's finding that an initial opportunity for FERC review is not a prerequisite to applying the *Mobile-Sierra* presumption of justness and reasonableness also increases the importance of the question whether the FERC is obligated to apply the *Mobile-Sierra* presumption of justness and reasonableness when third parties challenge a jurisdictional contract. A third-party, by definition, is not a party to the contract, and, thus, its first opportunity to review and comment upon a particular contract generally will be when the contract is filed with or otherwise reported to the FERC. Application of a strict *Mobile-Sierra* public interest mode of review at that stage would make it difficult for third parties to obtain modifications to the contract. This issue could be of particular significance for state commissions and state consumer advocates that typically participate in FERC proceedings to safeguard the interests of retail customers.[203]

201. *Id*. at 2759 (Stevens, J., dissenting) (observing that "[t]he Court has curtailed the agency's authority to interpret the terms 'just and reasonable' and thereby substantially narrowed FERC's discretion to protect the public interest by the means it thinks best").

202. Municipal Light Boards v. FPC, 450 F.2d 1341 (D.C. Cir. 1971); *see also* 18 C.F.R. § 385, 2001(b) 2008) ("[i]f any filing does not comply with any applicable statute, rate, or order, the filing may be rejected").

203. If the ability of third parties–including state public utility commissions and state consumer advocates–to object to contracts when they are initially filed at the FERC is interpreted to be more limited than in the past as a result of *Morgan Stanley*, one consequence could be closer scrutiny of electric and natural gas distribution company purchasing practices in state commission prudence reviews, the one situation where states may disallow pass-through of FERC approved costs. Pike County Light & Power Co. v. Pennsylvania Pub. Util. Comm'n, 465 A.2d 735, 738 (Pa. 1983) (holding that state public utility commission cannot disallow

The issue of whether the *Mobile-Sierra* presumption should be applied to third-party contract challenges has been subject to sharpened debate following the D.C. Circuit's ruling in *Maine PUC II*.[204] In *Maine PUC II*, a case decided shortly before *Morgan Stanley*, the D.C. Circuit ruled that, because "the *Mobile-Sierra* doctrine is designed to ensure contract stability *as between the contracting parties*,"[205] the doctrine does not apply to challenges brought by non-contracting third parties.[206] In light of the Supreme Court's subsequent decision in *Morgan Stanley*, the FERC and others requested rehearing of this aspect of *Maine PUC II*.[207] The FERC argued that the D.C. Circuit's conclusion in *Maine PUC II* that non-contracting third parties were not subject to the *Mobile-Sierra* public interest standard of review "directly conflict[ed]" with *Morgan Stanley*.[208] The D.C. Circuit denied rehearing without comment on October 6, 2008.[209] On remand from *Maine PUC*, the Commission required the parties to revise the settlement agreement at issue consistent with the D.C. Circuit's ruling.[210]

On March 18, 2009, the FERC filed a brief in response to the petition for writ of certiorari in the *Maine PUC II* proceeding.[211] In its brief, the FERC argued that "plenary review" by the Supreme Court was not warranted.[212] The FERC asserted that the *Maine PUC II* holding that *Mobile-Sierra* does not apply to third-party contract challenges did not conflict with any decision of any other

pass-through of FERC-approved wholesale rates but may disallow pass-through of such costs to the extent that the purchasing utility imprudently incurred the costs in light of available alternatives); *see also* Order No. 697-A, *Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities*, [Proposed Regs.] F.E.R.C. STATS. & REGS. ¶ 31,268 at 30,255-56, 73 Fed. Reg. 25,832 (2008) (to be codified at 18 C.F.R. pt. 35) (citing Kentucky West Virginia Gas Co. v. Pennsylvania Pub. Util. Comm'n, 837 F.2d 600, 609 (3d Cir. 1988); *Doswell Ltd. P'ship,* 50 F.E.R.C. ¶ 61,251 at 61,758 n.18 (1990)) (discussing state authority to disallow FERC-approved costs on imprudence grounds). If state commissions and consumer advocates may only challenge contracts in FERC proceedings subject to the *Mobile-Sierra* presumption and a "practically insurmountable" burden to overcome the presumption, states may afford closer scrutiny to the wholesale contracting decisions of state-regulated distribution utilities since, according to *Morgan Stanley*, it is the negotiation of the contract between the distribution utility and the FERC-regulated seller that creates the presumption of justness and reasonableness.

204. Main Pub. Utils. Comm'n v. F.E.R.C., 520 F.3d 464, 479 (D.C. Cir. 2008), *reh'g denied*, *Maine Pub. Utilities Comm'n v. F.E.R.C.,* No. 06-1403, *et al.* (October 6, 2008), *petition for writ of certiorari pending NRG Power Marketing, LLC v. Maine Pub. Utils. Comm'n,* No. 08-674 (December 22, 2008). As noted, as of the date of submission of this article, a petition for writ of certiorari seeking review of *Maine PUC II* is pending before the Supreme Court.

205. *Maine PUC II,* 520 F.3d at 479.

206. *Id.* at 478.

207. *Maine Pub. Utils. Comm'n v. F.E.R.C.*, No. 06-1403, "Petition of Respondent Federal Energy Regulatory Commission for Panel Rehearing and Suggestion for Rehearing *En Banc*" (D.C. Cir. August 8, 2008), (hereinafter "FERC Rehearing Request").

208. *Id.* at 2.

209. On remand from *Morgan Stanley,* the Nevada Attorney General's Bureau of Consumer Protection argued that, in light of *Maine PUC II,* its challenge to the contracts executed during the western power crisis could not be evaluated using the *Mobile-Sierra* public interest mode of review. In its initial order on remand, the FERC found that "it is premature to address this issue." *Nevada Power Co. and Sierra Pacific Power Co.,* 125 F.E.R.C. ¶ 61,312 at P 28 n.63 (2008), *reh'g pending*.

210. *Devon Power LLC*, 126 F.E.R.C. ¶ 61,027 (2009).

211. Brief of the FERC, NRG Power Marketing, LLC v. Maine Pub. Utils. Comm'n, No. 08-674, (S.Ct. Nov. 28, 2009).

212. *Id.* at 8.

court of appeals and suggested that the petitioners were overstating the practical significance of the *Maine PUC II* decision.[213] The "ordinary just-and-reasonable standard," the FERC told the Court, "would itself furnish substantial protection for established rates such as those at issue here."[214] The FERC acknowledged that the *Maine PUC II* ruling would have "the anomalous result of imposing a higher standard on contracting parties and the Commission acting on its own initiative than on non-parties challenging contract rates,"[215] but the FERC argued that it "should be able to mitigate that anomalous result by rejecting rate challenges that amount to inappropriate strategic behavior, such as a third-party complaint challenging a contract filed by a proxy for one of the contracting parties."[216] Although opposing "plenary review" by the Supreme Court, the FERC ultimately urged the Court to grant the petition for writ of certiorari, vacate *Maine PUC II* to the extent it rejected FERC's order on the *Mobile-Sierra* issue, and remand to the D.C. Circuit for further consideration in light of *Morgan Stanley*.[217]

Thus, as of the date of submission of this article, the applicability of the *Mobile-Sierra* presumption to third-party contract challenges remains a developing issue.

3. Effect On FERC Settlement Agreements

Morgan Stanley also raises interesting questions about the FERC's authority to approve and condition settlement agreements. The courts have indicated that the FERC has not only the right, but the obligation, to review a proposed settlement agreement to determine if the settlement will produce just and reasonable rates, terms and conditions for jurisdictional service.[218] The D.C. Circuit has observed that although the FERC must "give weight to the contracts and settlements of the parties before it,"[219] the fact that a proposal is included in a settlement "'does not establish without more the justness and reasonableness of its terms.'"[220]

The Courts of Appeals, however, have also found that FERC settlement agreements are contractual arrangements to which the *Mobile-Sierra* doctrine applies.[221] If settlements executed by the parties to FERC proceedings are *Mobile-Sierra* contracts, however, and if the presumption of justness and reasonableness applies regardless of initial FERC review of a contract as held by *Morgan Stanley*, the FERC's settlement approval authority could be subject to challenge to the extent the FERC applies something less stringent than the public

213. *Id.*

214. *Id.* at 10.

215. *Id.* at 11.

216. *Id.* at 11-12.

217. *Id.* at 12.

218. *Tejas Power Corp.*, 908 F.2d at 1003.

219. *Id.* (citing *Mobile* and *Sierra*).

220. *Id.* (quoting Mobil Oil Corp. v. FPC, 417 U.S. 283, 312-13 (1974)).

221. *See, e.g.*, Dominion Transmission, Inc. v. FERC, 533 F.3d 845 (D.C. Cir. 2008); Union Elec. Co. v. FERC, 890 F.2d 1193, 1194-95 (D.C. Cir. 1989).

interest analysis described in *Morgan Stanley* in evaluating a proposed settlement.

The FERC appears to have given this issue at least some consideration in seeking rehearing of the D.C. Circuit's ruling in *Maine PUC II*.[222] In arguing that settlements such as the one at issue in *Maine PUC II* were subject to *Mobile-Sierra* even against challenges by third parties, the FERC suggested that the Supreme Court's ruling would not interfere with its ability to review and approve settlements, arguing that "[t]he specific facts surrounding a negotiated settlement clearly are relevant to the Commission's review of that settlement in resolving an adjudicatory proceeding and its findings that the settlement, even one with a *Mobile-Sierra* provision applicable to future changes, is on balance just and reasonable."[223] The FERC went on to argue that "[t]hose same facts also might be relevant to whether that settlement, once adjudged just and reasonable, *later* may be upset under the *Mobile-Sierra* public interest standard – but not to whether *Mobile-Sierra* will apply to any such later challenge."[224] Thus, the FERC apparently takes the view that "in resolving an adjudicatory proceeding," it retains the authority to review a settlement for justness and reasonableness without applying the *Mobile-Sierra* presumption.[225]

While the FERC very well might argue successfully that a settlement resolving an adjudicatory proceeding, particularly one involving a tariff filing, must be reviewed under a more traditional just and reasonable standard rather than the stringent standard of *Mobile-Sierra* and *Morgan Stanley*, there would appear to be at least an argument that the FERC has limited ability to reject a settlement agreement negotiated by sophisticated parties to govern jurisdictional rates, terms and conditions. Given that the vast majority of FERC cases are resolved through settlement, restrictions on the FERC's authority to supervise such agreements could be significant.

As noted, the FERC's position had been that binding it to a stringent public interest standard upon the initial review of a contract would mean that "public regulation would consist of little more than rubber-stamping private contracts."[226] In light of the Supreme Court's holding that application of a strict *Mobile-Sierra* public interest mode of review does not, in fact, require an initial opportunity for the FERC to review a contract without the presumption of justness and reasonableness, the FERC and parties impacted by its regulation may have to confront arguments that the FERC's review of a proposed

222. FERC Rehearing Request, *supra* note 208.

223. *Id*. at 8.

224. *Id.* at 8-9.

225. Commissioners Kelly and Wellinghoff dissented from the FERC's decision to seek rehearing of *Maine PUC II*. *Maine Pub. Utilities Comm'n v. FERC*, No. 06-1403, Dissent of Commissioners Kelly and Wellinghoff (D.C. Cir. August 4, 2008). The dissenting Commissioners did not specifically contest the majority's view that *Maine PUC II*'s finding that *Mobile-Sierra* cannot be applied to contract challenges by third parties conflicted with *Morgan Stanley*. Instead, Commissioners Kelly and Wellinghoff disputed that the *Mobile-Sierra* presumption as articulated in *Morgan Stanley* applies to a *settlement* agreement that resolves an adjudicatory proceeding (such as the one at issue in *Maine PUC II*). The dissenting Commissioners argued that rehearing was unnecessary, and, to the extent the majority accepted the principle that the *Mobile-Sierra* presumption applies to settlements, potentially very harmful to the FERC's ability to fulfill its regulatory role under the FPA and NGA.

226. *Northeast Utilities*, 66 F.E.R.C. at p. 62,087.

settlement is subject to the *Mobile-Sierra* presumption of justness and reasonableness, rebuttable only upon a showing that the settlement would seriously harm the public interest within the meaning of *Morgan Stanley*. Such potential restriction on the FERC's decision-making authority was, in fact, one of the concerns articulated by Commissioners Kelly and Wellinghoff in their dissent from the decision to request rehearing of *Maine PUC II*.[227]

B. Challenges to the Applicability of The Mobile-Sierra Presumption and The Showing Required To Rebut The Presumption

As explained above, *Morgan Stanley* provided guidance concerning certain situations where the *Mobile-Sierra* presumption of justness and reasonableness will not apply, as well as clarification regarding how the presumption may be overcome, particularly in so-called "high rate" cases involving market-based contract rates. Some of the potential implications of the Supreme Court's decision on these issues are discussed below.

1. Market Manipulation By A Contract Party

The Supreme Court indicated that the *Mobile-Sierra* presumption will not apply where "the 'dysfunctional' market conditions under which the contract was formed were caused by illegal action of one of the parties."[228] This, in fact, was one of the issues the Supreme Court remanded to the FERC for further proceedings.[229] While it is possible that this issue could arise in other contexts, this exception to *Mobile-Sierra* presumably will be most relevant to market-based sales of power under the FPA.

The scope of the Supreme Court's "market manipulation" exception will need to be developed in individual proceedings, as the Supreme Court's description of the exception indicates a need for case-specific adjudication: "if it is clear that one party to a contract engaged in such extensive unlawful market manipulation as to alter the playing field for contract negotiations, the Commission should not presume that the contract is just and reasonable."[230]

The Court emphasized the need for a "causal connection" between the conduct and the rate.[231] It is difficult to speculate at this juncture what the FERC may regard–and what the Courts may uphold–as unlawful market manipulation that is so "excessive" as to "[a]lter[] the playing field for contract negotiations,"[232] or how specific a showing will be required to establish a "causal connection" between market manipulation and the contract, although the FERC has begun to flesh out the issues on remand from *Morgan Stanley.* In its initial order on remand from the Supreme Court's decision, the FERC established paper hearings to address these issues, stating that buyers presenting market

227. *Maine Pub. Utilities Comm'n*, No. 06-1403, Dissent of Commissioners Kelly and Wellinghoff at 5. The dissenting Commissioners argued that such an outcome "would result in significant decision-making authority being transferred from the Commission to the utility and other private parties entering into the settlement agreement." *Id.*

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

229. *Id.* at 2750-51.

230. *Id.* at 2750.

231. *Id.* at 2751.

232. *Id.* at 2750.

manipulation evidence "must demonstrate that a particular seller engaged in unlawful manipulation in the spot market *and* that such manipulation directly affected the particular contract or contracts to which the seller was a party."[233] The FERC noted that to be considered "unlawful" market manipulation, such manipulation had to have been illegal at the time it occurred.[234] With respect to the showing of a causal connection between the market manipulation and the contract rates, the FERC stated that "analysis of a generic link between the dysfunctional spot market and the forward markets is not adequate to establish a casual connection between a particular seller's alleged unlawful activities and the specific contract negotiations."[235]

2. Unequal Bargaining Power

The Supreme Court's clarification that the basis of the *Mobile-Sierra* presumption of legality is the arms-length negotiation between sophisticated parties "enjoying presumptively equal bargaining power"[236] also suggests potential avenues for challenging the applicability of the presumption.

While it is unlikely that many wholesale sellers or purchasers could be characterized as lacking sophistication, it is not difficult to imagine contract challenges grounded in arguments that there was not, in fact, an equality of bargaining power between the two contracting parties. Although such arguments may be foreseeable, any such arguments presumably would face an uphill battle. In *Morgan Stanley*, for instance, the Supreme Court appeared to regard the parties contracting under the FERC's market-based rate tariff program as possessing equal bargaining power notwithstanding market dysfunction, except to the extent that one party engaged in market manipulation that "alters the playing field for contract negotiations."[237] Likewise, the FERC's rules and policies requiring non-discriminatory open access to the electric transmission grid and the natural gas pipeline network, along with the prevalence of cost-based rates in these industry segments, likely would make it difficult to challenge application of a *Mobile-Sierra* presumption based on an allegation of unequal bargaining power in the electric transmission or natural gas transportation markets.[238] The Court's opinion nonetheless leaves open the question of whether a demonstration of unequal bargaining power between two contracting parties could support a finding in an individual case that the *Mobile-Sierra* presumption should not apply.

233. *Nevada Power Co. and Sierra Pacific Power Co. v. Enron Power Marketing, Inc.*, 125 F.E.R.C. ¶ 61,312 at P 28.

234. *Id.* at P 25 ("[w]hether any of the sellers in this case engaged in unlawful market activity in the spot market must be determined based on the relevant laws, regulations, orders, and tariffs in effect at the time of the Western energy crisis").

235. *Id.* at P 28. The FERC noted in this respect that the relationship between spot and forward market prices identified by its Staff in the 2003 Staff Report alone would be insufficient to establish such a casual connection. *Id.*

236. *Morgan Stanley*, 128 S. Ct. at 2746.

237. *Id.* at 2750.

238. In any case, the FERC generally follows a "tariff and service agreement" regulatory approach in the natural gas transportation and electric transmission segments, which tends to render *Mobile-Sierra* less of an issue, as the FERC has noted. *Standard of Review for Modifications to Jurisdictional Agreements,* FERC Stats. & Regs. ¶ 32,596 at PP 5-6 (2005), 71 Fed. Reg. 303 (Jan. 4, 2006), *withdrawn* 125 F.E.R.C. ¶ 61,310 (2008).

3. Excessive Burden

When he sat on the D.C. Circuit, then-Judge Scalia called the *Mobile-Sierra* public interest test "practically insurmountable" when applied to a public utility seeking to unilaterally increase a rate set by contract.[239] Now writing for the Supreme Court, Justice Scalia explained that "[t]he standard for a buyer's challenge must be the same, generally speaking, as the standard for a seller's challenge: The contract rate must seriously harm the public interest."[240] If this standard is "practically insurmountable" in the low-rate context, the Court's suggestion that the standard is the same in a high rate case at first blush indicates a similarly stringent test for challenges to high-rate contracts. However, the Court's further discussion of the standard–as well as its remand to the FERC–leave open the question whether the showing necessary to overcome the *Mobile-Sierra* presumption is as strict in circumstances that differ from the those at issue in the original decisions.

The Court acknowledged, for instance, that the three *Sierra* public interest factors "are not all precisely applicable to the high-rate challenge of a purchaser . . . ; and that those three factors are in any event not the exclusive components of the public interest."[241] Thus, the FERC will continue to have discretion to consider a variety of factors in evaluating whether a contract "seriously harms the public interest."[242]

While apparently leaving the FERC discretion in assessing what circumstances might justify overcoming the *Mobile-Sierra* presumption of justness and reasonableness, the Court did confirm that the "excessive burden" factor identified in *Sierra* is also applicable in a "high rate" case, except that the relevant inquiry is whether any customers of the purchaser would be excessively burdened.[243] Significant in this regard is the Court's holding that, in assessing the rate impact burden on the consumer, the FERC should look to the "disparity between the contract rate and the rates consumers would have paid (but for the contracts) further down the line, when the open market was no longer dysfunctional."[244] The Court's language indicates that the relevant comparison for determining an "excessive burden" rate impact down the line is between the high contract rates (in this case allegedly influenced by market dysfunction) and the rate impact that lower subsequently available contract prices would have had on consumers (*e.g.*, once market dysfunction had been resolved).[245] In its initial order on remand from *Morgan Stanley* the FERC explained that "[a] relevant factor in this down-the-line analysis is the cost of substitute power in the absence of the contracts."[246] The FERC stated in this respect that "the appropriate measure of the cost of substitute power at a particular point in time in the duration of a contract is the actual market prices available at that time for

239. *Papago*, 723 F.2d at 954.

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

241. *Id*. at 2747.

242. *Id.*

243. *Id*.

244. *Id.* at 2750.

245. *Id.* at 2749-50.

246. *Nevada Power Co. and Sierra Pacific Power Co. v. Enron Power Marketing, Inc.*, 125 FERC ¶ 61,312 at P 20.

comparable forward contracts."[247] Thus, notwithstanding the Supreme Court's conclusion that the presence of dysfunction alone is not enough to render the *Mobile-Sierra* presumption inapplicable, the Court's "down the line" holding provides an avenue for modifying market-based rate contracts alleged to have been influenced by market dysfunction.

Any such challenge, of course, would still have to show that the rate burden on customers was "excessive." The Supreme Court indicated in this regard that rates that merely exceed marginal cost would not satisfy the standard,[248] and that the increased rates paid by the purchasers' customers would have to be "so great that, even taking into account the desirability of fostering market-stabilizing long-term contracts, the rates impose an excessive burden on consumers or otherwise seriously harm the public interest."[249] The Court also explained that "[t]he FPA recognizes that contract stability ultimately benefits consumers, even if short-term rates for a subset of the public might be high by historical standards."[250] The FERC's initial remand order did not identify any particular threshold necessary to show that the rate impact burden on consumers was "excessive."[251]

Finally, parties seeking to modify contracts subject to the *Mobile-Sierra* presumption may also pursue the Court's suggestion that "circumstances exogenous to contract negotiations" are "relevant" in evaluating whether a contract rate imposes an "excessive burden" on consumers.[252] This statement suggests that the FERC, in determining that the burden on consumers imposed by a contract is "excessive," may consider not only the absolute magnitude of a "high rate," but also whether the rate was increased by unusual circumstances such as "[n]atural disasters and market manipulation by entities not parties to the challenged contract."[253]

Thus, while the Supreme Court has provided further guidance regarding application of *Mobile-Sierra* in a "high rate" case, the opinion ultimately leaves to the FERC the issue of "how high is too high"–an issue about which the First Circuit has observed "[v]ery little useful precedent exists."[254]

V. CONCLUSION

In *Morgan Stanley*, the Supreme Court re-affirmed the role of contracts in the regulatory schemes established by the FPA and the NGA. Indeed, the Court rejected the notion that contracts' compliance with the statutory just and reasonable standard is based on the FERC's approval, locating the basis for the lawfulness of the rate in the fact that two sophisticated parties of equal bargaining power, negotiated it. In so ruling, however, the Court left open

247. *Id.*

248. *Id.* at 2748-49.

249. *Id.* at 2750.

250. *Id.* at 2749.

251. *Nevada Power Co. and Sierra Pacific Power Co. v. Enron Power Marketing, Inc.*, 125 FERC ¶ 61,312 at PP 19-23 (2008).

252. *Morgan Stanley*, 128 S. Ct. at 2748 n.4.

253. *Id.* (quoting *id.* at 2758 (Stevens, J., dissenting)).

254. *Boston Edison*, 233 F.3d at 68.

numerous questions concerning application of *Mobile-Sierra* that the FERC likely will have to confront in the future.