RECONCILING MARKET-BASED RATES WITH THE JUST AND REASONABLE STANDARD

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"It is not as speedy or as simple a process to interpret a statute out of existence as to repeal it, but with time and patient skill it can often be done."[1]

I. INTRODUCTION

The legal and economic fallout from the 2000–2001 western electricity crisis continues as western utilities seek relief from expensive long-term supply contracts executed during the crisis (long-term supply contracts). The Ninth Circuit Court of Appeals is grappling with the question of what role the Federal Energy Regulatory Commission (FERC) is statutorily required to play in addressing the continuing fallout.[2] Much discussion has revolved around the question of whether the FERC may predetermine that market-based rates (MBRs) are just and reasonable and therefore in conformance with the basic statutory requirement of the Federal Power Act (FPA).[3]

With market-based tariffs, the FERC has exercised procedures by which it: (a) grants MBR authority to an electricity seller, under section 205 of the FPA,[4] after finding that the seller does not have market power or has taken steps to mitigate market power; (b) assures competitive markets through ongoing reporting requirements and market monitoring; and (c) penalizes anti-competitive behavior by revoking MBR authority. In the context of the western electricity crisis, the FERC proved adept at granting MBR authority, but ineffective in the assurance and penalty areas. Largely ignored is the issue of buyer and consumer remedies when market dysfunction and regulatory failure result in unjust and unreasonable rates.

In the western electricity markets, regulatory reform exposed deep market imperfections that regulators failed to adequately address. As FERC Chairman Kelliher recently stated, the FERC has struggled to "find the right balance between competition and regulation"[5] and "develop market rules to govern competition in wholesale power markets in a manner consistent with its legal duties."[6] More bluntly, former FERC Chairman Wood recently stated that the "FERC was giving out deregulation certificates without doing . . . an intellectually honest job of saying, 'Is this really a competitive market or not?'."[7]

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1. J.C. GRAY, THE NATURE AND SOURCES OF THE LAW 180 (1909).

2. California *ex rel.* Lockyer v. FERC, 383 F.3d 1006 (9th Cir. 2004), *petition for reh'g filed*, No. 02-73093 (9th Cir. 2004); Pub. Util. Dist. No. 1 v. FERC, No. 03-74208 (9th Cir. filed June 1, 2004).

3. Federal Power Act § 205(a), 16 U.S.C. § 824d(a) (2000); *see generally* Gerald Norlander, *May the FERC Rely on Markets to Set Electric Rates?*, 24 ENERGY L.J. 65 (2003).

4. 16 U.S.C. § 824d.

5. Hon. Joseph T. Kelliher, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26 ENERGY L.J. 1, 1 (2005).

6. *Id.* at 11.

7. J. Beattie, *Wood: PUHCA Spurring Market Power Concerns*, ENERGY DAILY, June 23, 2005, at 3.

Further, he opined that "[y]ou don't bet on a competitive market by giving deregulation [authority] and hoping [competitive markets] will come, but unfortunately . . . that's what we did in the mid-90s."[8]

The foregoing comments prompt the following question: Because the FERC is responsible under the FPA for regulating and overseeing the U.S. wholesale electricity industry, and ensuring just and reasonable rates, what are the FERC's remedial obligations when an over-reliance on the market results in regulatory failure and unjust and unreasonable rates? After an overview of events, regulatory principles, and relevant case law, this article examines: (1) whether an initial market-power test, plus reporting requirements and market monitoring, may serve as a valid proxy for traditional just and reasonable rate review; (2) what, if any, *ex post* regulatory review of MBRs may be necessary; and (3) with respect to the long-term supply contracts, what additional remedial and preventive measures should be considered.

II. BACKGROUND

A. The Western Electricity Crisis

The events of the western electricity crisis have been well described elsewhere,[9] and merely require a brief summary here. In May 2000, a confluence of factors began impacting the western electricity markets, including a flawed market design in California, ineffective regulatory oversight, and market manipulation or "gaming" by merchant electricity sellers.[10] In August 2000, San Diego Gas and Electric (SDG&E) filed a complaint with the FERC against all sellers into California's wholesale electricity spot markets, which prompted the Western Refund Proceeding to determine the justness and reasonableness of spot prices.[11] A series of FERC Orders followed.[12] In a December 2000 Order, the FERC, *inter alia*: (1) eliminated the FERC-sponsored California PX spot market, thereby pushing market participants into the long-term markets and incidentally driving up prices in those markets; (2) created a benchmark $74 per megawatt hour (MWh) price for the long-term markets, based on historical data, for measuring the justness and reasonableness of new long-term supply contracts; (3) required that market participants schedule 95% of consumer demand or "load" prior to the real-time electricity market, limiting real-time balancing transactions to only 5% of total load; (4) forced California's

8. *Id.*

9. *See, e.g.*, Peter Navarro & Michael Shames, *Electricity Deregulation: Lessons Learned from California*, 24 ENERGY L.J. 33 (2003) [hereinafter Navarro & Shames].

10. The market gaming included: (a) producing false transmission congestion and improperly obtaining payments for relieving the congestion; (b) boosting prices by taking power plants off line and strategically withholding capacity at specific times and places; (c) circumventing in-state price caps through megawatt laundering, or exporting electricity to neighboring states and then importing it as out-of-state electricity not subject to price caps; and (d) withholding supply from the day-ahead market and selling it at inflated prices into the real-time market.

11. *San Diego Gas & Elec. Co.*, 92 F.E.R.C. ¶ 61,172, 61,606 (2000).

12. *San Diego Gas & Elec. Co.*, 93 F.E.R.C. ¶ 61,121 (2000); *San Diego Gas & Elec. Co.*, 93 F.E.R.C. ¶ 61,294, 61,981 (2000); *San Diego Gas & Elec. Co.*, 94 F.E.R.C. ¶ 61,245 (2001); *San Diego Gas & Elec. Co.*, 95 F.E.R.C. ¶ 61,115 (2001); *San Diego Gas & Elec. Co.*, 95 F.E.R.C. ¶ 61,418 (2001); *San Diego Gas & Elec. Co.*, 96 F.E.R.C. ¶ 61,120 (2001); *San Diego Gas & Elec. Co.*, 97 F.E.R.C. ¶ 61,293 (2001); *San Diego Gas & Elec. Co.*, 99 F.E.R.C. ¶ 61,160 (2002); *San Diego Gas & Elec. Co.*, 102 F.E.R.C. ¶ 61,317 (2003).

investor-owned electric utilities (IOUs) to enter into expensive long-term supply contracts with merchant electricity sellers; and (5) initiated market-monitoring and price-mitigation plans, including a "soft" price cap in the California spot markets.[13]

The FERC's December 2000 Order did little to mitigate the immediate crisis, and in February 2001's First Extraordinary Session the California legislature passed AB 1X. Under AB 1X, the California Department of Water Resources (DWR) became authorized to purchase electricity from merchant electricity sellers, under long-term bilateral contracts, on behalf of California's financially distressed IOUs. Market and regulatory conditions had forced the California IOUs to buy high in the wholesale markets and sell low in the retail markets, eventually leaving them with insufficient credit capacity to continue purchasing electricity for their customers.[14]

Throughout the spring of 2001, officials in California and other western states increased pressure on the FERC to address unjust and unreasonable wholesale prices. Finally, in a June 2001 Order, the FERC imposed a regional "hard" price cap in the western spot markets, which triggered when California's generating reserve margin fell below 7%.[15] Because the hard price cap was applied throughout the western states, it ended the widespread practice of megawatt laundering. The regional June 2001 price caps—combined with long-term bilateral purchases by the DWR, California's IOUs, and other western utilities—eventually lowered wholesale prices to reasonable levels during the summer of 2001. However, western utilities remain burdened with expensive long-term supply contracts that were entered into after the December 2000 Order and before the June 2001 Order, leaving consumers burdened with high retail rates. Because of interconnected markets, the failed regulatory reform effort in California spilled into the other western states of Montana, Nevada, Oregon, and Washington, all of which experienced inflated wholesale electricity prices.

B. Regulatory Overview

When an industry that has long been tightly regulated is subjected to market forces, inherited structures will impact nascent markets and how they develop.[16] Regulatory reform in the U.S. wholesale electricity industry has exposed deep market flaws associated with the physical and technical idiosyncrasies of electricity and the inherited patterns of production and delivery. For example, electricity cannot be stored, travels according to the laws of physics and not the laws of contract, requires a complex and controversial infrastructure, has an inelastic demand, and is critical to our modern economy. Only belatedly, through its support of regional transmission organizations (RTOs) and the well-

13. 93 F.E.R.C. ¶ 61,294, at 61,982. Under the soft price cap, "[s]ellers bidding at or below [a $150] breakpoint . . . receive[d] the market clearing price[], but no[] more than $150 per MW. If sellers bidding above [$150 were] needed to clear the market, they . . . receive[d] their actual bids." *Id.* at 61,983. Contrary to intent, electricity prices soared as high as $1,500 per MWh within a week of the soft cap's introduction.

14. For example, Pacific Gas and Electric (PG&E) filed for bankruptcy protection on April 6, 2001. *PG&E Seeks Bankruptcy*, CNN MONEY, Apr. 6, 2001.

15. 95 F.E.R.C. ¶ 61,418.

16. John R. Meyer & William B. Tye, *Toward Achieving Workable Competition in Industries Undergoing a Transition to Deregulation: A Contractual Equilibrium Approach*, 5 YALE J. ON REG. 273 (1988).

intentioned but ill-fated standard market design (SMD),[17] has the FERC begun to seriously address market structure. Previously, the FERC appears to have operated under the belief that efficient structures would develop and evolve on their own, through intrinsic self-correcting market forces and mechanisms. During the western electricity crisis, the FERC maintained its faith in market forces even in the midst of overwhelming evidence of market dysfunction.

In retrospect, the western electricity markets were not mature markets that could efficiently self-correct after an external shock. They were nascent and deeply undeveloped markets with structural flaws that could be gradually corrected only through diligent regulatory oversight and strategic intervention. The hard price cap of June 2001, which effectively ended the western electricity crisis, was imposed a full year after the crisis began. Arguably, if the FERC had imposed a hard price cap rather than a soft price cap in December 2000, the crisis would have been largely mitigated.[18] The FERC's response to the electricity crisis resulted in prolonged regulatory lag, which translated into unjust and unreasonable rates.[19] Market and regulatory failure allowed for inflated spot and forward prices throughout the West, with these prices only correcting after the belated FERC intervention of June 2001.

The theory of economic regulation, introduced by George Stigler[20] and advanced by Sam Peltzman,[21] argues in part that regulatory agencies act in favor of consumers when prices are high, and conversely act in favor of producers when prices are low. In the context of the U.S. electricity industry, the western experience supports this theory. In June 2001, when the FERC eventually exercised decisive intervention in the West, it imposed hard price caps in the spot markets to protect consumers against market dysfunction and inflated prices. Conversely, when wholesale electricity prices declined throughout the U.S. following the Enron bankruptcy of December 2001,[22] the FERC protected producers and sellers by upholding western long-term supply contracts executed when prices were high. In protecting sellers of long-term supply contracts, the FERC invoked sanctity of contract arguments and applied a stringent public-interest standard of review to the contracts, rather than the statutory just and reasonable standard.

C. *Mobile-Sierra*

The stringent public-interest standard of review has its origins in two 1950s-era Supreme Court cases.[23] In *United Gas Pipe Line Co. v. Mobile Gas Service*

17. Google, *Definitions of Regional Transmission Organizations*, http://www.google.com/search?hl=en&q=define%3A+regional+transmission+organizations (last visited Sept. 27, 2005); LookSmart, *Electric Perspectives: A Set of Principles for Standard Market Design*, http://www.findarticles.com/p/articles/mi_qa3650/is_200209/ai_n9140788/print (last visited Sept. 27, 2005).

18. Navarro & Shames, *supra* note 9, at 54.

19. Regulatory lag was so extreme that a Senate Committee later described the FERC as being "asleep at the switch." *See Asleep at the Switch: FERC's Oversight of Enron Corporation: Hearing Before the S. Comm. on Governmental Affairs*, 107th Cong. (2002).

20. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

21. Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 227 (1976).

22. Press Release, Enron Corp., Enron Files Voluntary Petitions for Chapter 11 Reorganization; Sues Dynegy for Breach of Contract, Seeking Damages of at least $10 Billion (Dec. 2, 2001), *available at* http://www.enron.com/corp/pressroom/releases/2001/ene/PressRelease11-12-02-01letterhead.html.

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

Corp. (*Mobile*), the United Gas Pipeline Company (United) filed a request with the Federal Power Commission (FPC) to charge its customer, Mobile Gas Service Corporation (Mobile), a higher rate than had previously been approved by the FPC and incorporated within the United-Mobile long-term supply contract. The FPC initially approved the rate increase, but the Third Circuit subsequently held that the FPC should have rejected United's request to increase its rate above the contractual rate. In affirming the Third Circuit's decision, the Supreme Court held that for United to raise its rate without Mobile's consent, United must first show that the contractual rate was "so low as to conflict with the public interest . . . ."[24]

Similarly, in *FPC v. Sierra Pacific Power Co.* (*Sierra*), PG&E tried to charge its customer, Sierra Pacific Power Company (Sierra), a higher rate than had previously been approved by the FPC and incorporated within the PG&E-Sierra long-term supply contract. As in *Mobile*, the Supreme Court held that PG&E could not increase its rate absent a rigorous showing that the existing contractual rate was contrary to the public interest. Both *Mobile* and *Sierra* were consumer-protection cases in accordance with the spirit of the FPA. In these two cases, the Court required that the FPC expand its analysis of justness and reasonableness to include whether the public interest would be served by allowing a seller to unilaterally increase rates that the FPC had previously reviewed and approved. In other words, the Court created additional consumer protections by placing a judicial gloss over the doctrine of justness and reasonableness.

In sum, the Supreme Court decisions in *Mobile* and *Sierra* (Mobile-Sierra) stand for the proposition that when a FERC-jurisdictional seller has contractually assumed the burden of a low rate, it can increase that rate only if it is "so low as to adversely affect the public interest—as where it might impair the financial ability of the [seller] to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory."[25] Regrettably, this reasonable approach to protecting consumers was subsequently expanded by the District of Columbia Circuit to include contract modifications of almost any kind,[26] resulting in a stringent public-interest standard of review that has been described as "practically insurmountable."[27] Prior to its distortion by the District of Columbia Circuit, Mobile-Sierra held a logical place within the statutory context of the FPA, which fundamentally is a consumer-protection statute. In the FPA context, the stringent public-interest standard of review protects buyers from contractually unauthorized price increases by sellers. Former FERC Commissioner Massey summarized this point well:

> The Mobile-Sierra doctrine arose in a cost-of-service regime. Once approved by the Commission as just and reasonable, a contract, rate, or classification should not

Co., 350 U.S. 348 (1956); *see* Carmen L. Gentile, *The Mobile-Sierra Rule: Its Illustrious Past and Uncertain Future*, 21 ENERGY L.J. 353, 367 (2000).

24. *Mobile*, 350 U.S. at 345.

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

26. *See, e.g.*, Potomac Elec. Power Co. v. FERC, 210 F.3d 403 (D.C. Cir. 2000), *aff'g, Potomac Elec. Power Co.*, 85 F.E.R.C. ¶ 61,160 (1998), *reh'g denied*, 87 F.E.R.C. ¶ 61,030 (1999). Here, the D.C. Circuit applied the Mobile-Sierra standard in denying a transmission customer's request to reduce its contractual transmission rate to the level of a lower rate available under a new open-access transmission tariff.

27. Papago Tribal Util. Auth. v. FERC, 723 F.2d 950, 953 (D.C. Cir. 1983), *cert. denied*, 467 U.S. 1241 (1984).

> be modified unless a higher standard justifies the modification. This makes sense. Most cases arose in the context of a seller making a filing to justify a higher rate. In such a case, the doctrine appeared to have a customer protection rationale.[28]

In the aftermath of the western electricity crisis, Commissioner Massey recognized that the FERC is free to disregard Mobile-Sierra when reviewing requested modifications to the long-term supply contracts:

> The Mobile-Sierra case law involves contracts negotiated under a cost-of-service regime, and thus we do not know how the courts would instruct the Commission to address contracts negotiated in a market-based regime, especially under market conditions characterized by dysfunctional market rules, widespread manipulative conduct, and a lack of effective regulatory oversight. We are on new ground here, and the Commission is free to decide what circumstances give rise to the public interest.[29]

Commissioner Massey's observations are well supported by precedent. In *Northeast Utilities Service Company* (*Northeast II*), the FERC declared that the public-interest standard cannot be practically insurmountable in all cases, and in certain circumstances a more flexible standard of review than that of Mobile-Sierra is appropriate.[30] The FERC made this determination despite that *Northeast II* involved contracts containing so-called "Mobile-Sierra clauses." These clauses specify in advance that any unilateral request to change a contractual rate, after the FERC has initially found the rate to be just and reasonable under section 205 of the FPA, will be reviewed using a public-interest standard.

In upholding the FERC's application of a more flexible public-interest standard of review, the Court differentiated *Northeast II* from *Sierra* by characterizing *Sierra* as a "low rate" case, where the seller was trying to increase a customer's rate above a contractually allowed rate. In a non-low rate case, the Court held that a more flexible public-interest standard can apply and that "[i]t all depends on whose ox is gored and how the public interest is affected."[31] Pursuant to *Northeast II*, the FERC is free to apply one of three standards of review to issues of contract reformation, depending on the circumstances: (1) the statutory just and reasonable standard under the FERC's general public-interest authority, (2) the practically insurmountable Mobile-Sierra public-interest standard, and (3) the more flexible *Northeast II* public-interest standard.

In the cases dealing with the long-term supply contracts, a central question has been whether a market-based contractual rate may be predetermined just and reasonable when a dedicated section 205 FERC review was never performed. For example, if the FERC does not initially determine that an MBR is just and reasonable, then it can be argued that a condition precedent to a contractual rate based on that MBR was never satisfied. Under this reasoning, the presence of a Mobile-Sierra clause, the validity of which depends upon a prior FERC determination that the contractual rate is just and reasonable, would not present a barrier to contract reformation. In effect, because the contractual rate never received a legally sufficient first review under the FPA's just and reasonable

28. *Pub. Utils. Comm'n of Cal.*, 103 F.E.R.C. ¶ 61,354, 62,446 (2003) (emphasis omitted) (Massey, Comm'r, dissenting).

29. *Id.* at 62,448–49 (emphasis omitted).

30. *Ne. Utils. Serv. Co.*, 66 F.E.R.C. ¶ 61,332, 62,076 (2004).

31. Ne. Utils. Serv. Co. v. FERC, 55 F.3d 686, 690–91 (1st Cir. 1995).

standard, the Mobile-Sierra clause was never valid in the first instance because a condition precedent was not satisfied. Therefore, a retrospective just and reasonable rate review, followed by potential contract reformation and refunds, would be required.

III. MARKET-BASED RATE AUTHORITY

The first question to be examined is whether an initial market-power test, plus reporting requirements and market monitoring, may serve as a valid proxy for traditional just and reasonable rate review. Under cost-based ratemaking, establishing what is just and reasonable is not an exact science, but can be accomplished with some precision based on calculated costs. In contrast, establishing what is just and reasonable under market-based ratemaking is more complicated. In fact, the courts have held that "the prevailing price in the marketplace cannot be the final measure of 'just and reasonable' rates . . . ."[32] Nonetheless, "*[i]n a competitive market*, where neither buyer nor seller has significant market power, *it is rational to assume that the terms of their voluntary exchange are reasonable*, and specifically to infer that price is close to marginal cost, such that the seller makes only a normal return on its investment."[33]

According to *Elizabethtown Gas v. FERC*, "*when there is a competitive market* the FERC may rely upon market-based prices in lieu of cost-of-service regulation to assure a 'just and reasonable' result."[34] Because of the imprecision in determining the justness and reasonableness of MBRs, the courts have adopted a "zone of reasonableness" test, where rates can be neither "less than compensatory" nor "excessive."[35] *Farmers Union Central Exchange, Inc. v. FERC* emphasizes that keeping rates within the zone of reasonableness requires a proper regulatory scheme: "[m]oving from heavy to lighthanded regulation within the boundaries set by an unchanged statute can, of course, be justified by a showing that *under current circumstances* the goals and purposes of the statute will be accomplished through substantially less regulatory oversight."[36]

A combined reading of *Elizabethtown Gas* and *Farmers Union* suggests a syllogism between "when there is a competitive market" and "under current circumstances." In other words, *when there is a competitive market*, light-handed regulation can be justified by a showing that the goals and purposes of the FPA will be accomplished through substantially less regulatory oversight. Accordingly, if the predicate "when there is a competitive market" is not satisfied, it appropriately follows that light-handed regulation cannot be justified.

It may be rational for the FERC to infer a competitive market with respect to a seller when (1) the seller has passed a recent market-power test and complies with rigorous reporting requirements, and (2) the FERC is diligent in carrying out its market monitoring and mitigation responsibilities. However, it is not rational for the FERC to infer a competitive market with respect to a seller when (1) the market-power test that the FERC relies upon is flawed or conducted so

32. FPC v. Texaco, Inc., 417 U.S. 380, 398 (1974).

33. Tejas Power Corp. v. FERC, 908 F.2d 998, 1004 (D.C. Cir. 1990) (emphasis added).

34. Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870 (D.C. Cir. 1993) (emphasis added).

35. Farmers Union Cent. Exch., Inc. v. FERC, 734 F.2d 1486, 1502 (D.C. Cir. 1984).

36. *Id.* at 1510 (citation omitted) (citing Black Citizens for a Fair Media v. FCC, 719 F.2d 407, 413 (D.C. Cir. 1983)).

long ago as to be irrelevant, (2) reporting requirements are inadequate or not complied with, and (3) the FERC has not properly monitored the markets and intervened as necessary to ensure market integrity.

If the FERC cannot assure a competitive market with respect to any or all sellers, then according to *Elizabethtown Gas* and *Farmers Union* it cannot ensure just and reasonable rates as required by the FPA. As the Ninth Circuit recently confirmed, market-based tariffs are "conditioned on the existence of a competitive market."[37] The court upheld the FERC's authority to rely on MBRs so long as market-based tariffs are not "structured so as to virtually deregulate an industry and remove it from statutorily required oversight."[38] To preclude that possibility, the court declared that mechanisms must be in place to "enable [the] FERC to determine whether the rates were 'just and reasonable' and whether market forces were truly determining the price."[39]

Ostensibly, at the time of the western electricity crisis, the FERC required sellers with MBR authority "to inform the Commission . . . of any change in status that would reflect a departure from the characteristics the Commission has relied upon in approving market-based pricing"[40] or "to report such changes every three years in conjunction with an updated market analysis."[41] Plus, the FERC required that MBR sellers file quarterly reports on individual transactions. However, in the western electricity markets, the FERC did not adequately monitor and enforce these reporting requirements.

In describing regulatory failures in the West, the Ninth Circuit concluded that the FERC "abdicated" its market monitoring responsibilities, and that the FERC's market monitoring "was, for all practical purposes, non-existent while energy prices skyrocketed . . . ."[42] The court further stated that when the FERC "does not engage in an active ongoing review, the only arguably serious regulatory screening that exists is FERC's initial determination with respect to a seller's market power—a determination that may bear little or no relation to the realities of subsequent circumstances."[43]

After the western electricity crisis and subsequent Ninth Circuit finding that the FERC had failed to adequately fulfill its market monitoring responsibilities, the FERC began strengthening MBR sellers' reporting requirements[44] and the enforcement of those requirements.[45] For example, the February 2005 rule changes have standardized MBR sellers' reporting requirements for changes in status. A change in status refers to any change that implicates the FERC's grant of MBR authority based on an initial market-power analysis. In the new rule, the FERC states that "[t]o carry out its statutory duty under the FPA to ensure that [MBRs] are just and reasonable, the Commission must rely on [MBR] sellers to

37. California *ex rel.* Lockyer v. FERC, 383 F.3d 1006, 1012 (9th Cir. 2004) (citing La. Energy & Power Auth. v. FERC, 141 F.3d 364, 365 (D.C. Cir. 1998)).

38. *Id.* at 1014.

39. *Lockyer*, 383 F.3d at 1014.

40. *Heartland Energy Servs., Inc.*, 68 F.E.R.C. ¶ 61,223, 62,066 (1994).

41. *Delmarva Power & Light Co.*, 76 F.E.R.C. ¶ 61,331, 62,584 (1996).

42. *Lockyer*, 383 F.3d at 1014–15.

43. *Id.* at 1017.

44. Order No. 2001, *Revised Public Utility Filing Requirements*, [Regs. Preambles] F.E.R.C. STATS. & REGS. ¶ 31,127, 30,120 (2002), 67 Fed. Reg. 31,043, 31,046 (2002) (codified at 18 C.F.R. pts. 2, 35).

45. *Reporting Requirements for Changes in Status for Public Utilities with Market-Based Rate Authority*, 110 F.E.R.C. ¶ 61,097 (2005).

provide accurate, up-to-date information regarding any relevant changes in status, such as ownership or control of [jurisdictional] facilities and affiliate relationships."[46] Moreover, "[t]he Commission can best exercise its statutory duty to ensure just and reasonable rates by imposing an enforceable post-approval reporting requirement regarding changes in status."[47] With this recent rulemaking, the FERC is addressing past deficiencies in its reporting requirements, market monitoring, and mitigation.

The short answer to the question of "whether an initial market-power test, plus reporting requirements and market monitoring, may serve as a valid proxy for traditional just and reasonable rate review" is simply the following: An initial market-power test, plus reporting requirements and market monitoring, cannot thereafter "predetermine" that MBRs are just and reasonable, but can merely "presume" that MBRs are just and reasonable. A necessary predicate to the lawfulness of MBRs is that the markets are producing rates equivalent to those found in competitive markets. If this predicate is not satisfied at the time of contract formation, and if a party challenging a contractual rate as unjust and unreasonable can successfully show that this predicate was not satisfied, then the party should be entitled to a legally sufficient first review of the contractual rate under a just and reasonable standard.

The FERC's current posture is that a prior grant of MBR authority, in and of itself, is equivalent to a just and reasonable determination for subsequent contractual rates, and the fact that markets were dysfunctional at the time of contract formation is irrelevant. Such an argument renders illusory the fundamental consumer protections of the FPA. If the FERC fails to assure competitive markets through rigorous market-power analyses, reporting requirements, market monitoring, and mitigation, then no presumptive just and reasonable rate review has been performed, and the FERC's statutory duty to ensure just and reasonable rates is not satisfied. Put another way, if the FERC is successful in assuring competitive markets, then it is successful in presumptively ensuring just and reasonable rates.

IV. *EX POST* REVIEW

The second question to be examined is what, if any, *ex post* regulatory review of MBRs may be necessary. From the outset, it should be emphasized that any *ex post* review of MBRs is a second best solution. An *ex post* behavioral review of electricity markets, with remedies that include potential refunds, is much less desirable than an *ex ante* performance approach to assuring competitive markets. The best regulatory framework is one where *ex ante* structural design and the enforcement of market rules minimizes the potential for unjust and unreasonable rates.[48] Recent rulemaking, especially the Market Behavior Rules, indicates that the FERC is adopting such an *ex ante* approach.

An *ex post* review of MBRs should be limited to instances of combined market and regulatory failure. If the market fails but regulatory safeguards

46. Order No. 652, *Reporting Requirements for Changes in Status for Public Utilities with Market-Based Rate Authority*, [Reg. Preambles] F.E.R.C. STATS. & REGS. ¶ 31,175(2005), 70 Fed. Reg. 8253 (2005) (codified at 18 C.F.R. pt. 35).

47. *Id.* at 31,363.

48. *See* Peter Fox-Penner, Gary Taylor, Romkaew Broehm, & James Bohn, *Competition in Wholesale Electric Power Markets*, 23 ENERGY L.J. 281 (2002).

prevent or quickly mitigate consumer harm, then *ex post* reviews and further regulatory remedies may be unnecessary. Furthermore, merely because a market is inefficient does not mean that the market has failed. In competitive markets, inefficiencies promote normal price signals that encourage market participants to engage in desirable behaviors. By contrast, market failure occurs when flawed price signals encourage market participants to engage in undesirable behaviors.

Because normal price signals are needed to encourage desirable behaviors, the upper bound of the zone of reasonableness, at least with respect to short-term price increases in spot markets, is arguably different under an MBR regime as opposed to a CBR regime. As long as markets are competitive, an upward movement in spot prices may be justified as a means of attracting additional supply. With improved FERC reporting requirements, market monitoring, and mitigation, this upward movement might translate into a temporary safe harbor for electricity sellers, where refunds or other remedies are not contemplated.

If the FERC is properly carrying out its market monitoring and mitigation functions, then mere market inefficiencies are unlikely to be construed as market failures. More importantly, a regulatory correction by the FERC may ensure that a combined market and regulatory failure does not happen again. However, a prospective regulatory correction does not address the lingering effects of the western electricity crisis, for which retrospective remedies are required.

When it becomes obvious that markets have been noncompetitive and the regulatory system has not satisfactorily mitigated the effects of market failure, an *ex post* rate review based on the just and reasonable standard is required. Otherwise, the FERC will not have satisfied its statutory obligation, under section 205 of the FPA, to ensure just and reasonable rates in the first instance. Moreover, to the extent that MBR sellers have not complied with—and the FERC has not enforced—reporting requirements, which are an integral component of market-based tariffs, retrospective remedies in the form of profit disgorgement may be necessary.

In the West, markets and regulators were not up to the task of ensuring just and reasonable rates. Therefore, a cost-based review of the long-term supply contracts, based on a just and reasonable standard, is unavoidable. However, the FERC no longer appears to place blind faith in the self-correcting nature of markets, and the need for *ex post* cost-based reviews of MBRs, stemming from combined market and regulatory failure, is not likely to be a common issue going forward.

With respect to the western electricity crisis, the Ninth Circuit found that markets had not only been noncompetitive, but also that MBR sellers had not complied with, and the FERC had failed to enforce, the reporting requirements of market-based tariffs. Under these conditions, the Ninth Circuit declared that the FERC had broad remedial authority to order retroactive refunds for tariff violations, and that this refund authority was inherent in the FERC's authority to approve market-based tariffs in the first instance.[49] The refund authority described by the Ninth Circuit is similar to the refund authority for tariff violations contained in the FERC's Market Behavior Rules, issued some ten months earlier.[50]

49. California *ex rel.* Lockyer v. FERC, 383 F.3d 1006, 1015 (9th Cir. 2004).

50. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 F.E.R.C. ¶ 61,218 (2003), *reh'g denied*, 107 F.E.R.C. ¶ 61,175 (2004), *appeal docketed*, No. 04-1168 (2004).

V. REMEDIAL AND PREVENTIVE MEASURES

The third question to be examined is, with respect to the long-term supply contracts, what remedial and preventive measures should be considered. As stated above, the FERC has already adopted new preventive measures in the form of Market Behavior Rules. The purpose of the FERC's Market Behavior Rules is to protect wholesale electricity customers from market abuses, and it conditions a seller's MBR authority on following the rules. In fact, the FERC found that existing market-based tariffs were unjust and unreasonable precisely because they did not contain clearly defined rules against noncompetitive behavior: "Without such behavioral prohibitions, the Commission will not be able to ensure that rates are the product of competitive forces and thus will remain within a zone of reasonableness."[51] Logically, if market-based tariffs were unjust and unreasonable prior to promulgation of the Market Behavior Rules, then those same market-based tariffs were unjust and unreasonable at the time of the western electricity crisis, when the long-term supply contracts were executed.

When the Market Behavior Rules were adopted on December 17, 2003, they were automatically incorporated into all market-based tariffs, in what amounted to a generic contract modification under the FERC's general public-interest authority. With respect to broad public policy or restructuring initiatives, the FERC has often modified contracts under its general public-interest authority.[52] The Supreme Court has affirmed the FERC's statutory authority under the FPA to generically alter private contracts, when the public interest so requires, in implementing broad national policy.[53] The FERC's public-interest authority to modify contracts is at its strongest when acting on an industry-wide basis and the contracts at issue are obstacles to achieving regulatory objectives.[54]

The principle remedy for violating the Market Behavior Rules is disgorgement of profits. The disgorgement remedy under the Market Behavior Rules differs from the refund mechanism under section 206 of the FPA,[55] which permits refunds only for a statutorily prescribed refund effective period. Furthermore, a section 206 refund is limited to amounts charged above a just and reasonable rate. In contrast, the Market Behavior Rules are incorporated into market-based tariffs, with violations made subject to full disgorgement of profits. The disgorgement remedy is consistent with the FERC's broad remedial authority, as recognized by the courts, to redress tariff violations when protecting the public interest.[56]

The Ninth Circuit has found that the FERC may employ a similar disgorgement remedy for violations of market-based tariffs during the western

51. 105 F.E.R.C. ¶ 61,218, at 62,142.

52. *See, e.g.*, Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Wellhead Decontrol*, [Regs. Preambles 1991–1996] F.E.R.C. STATS. & REGS. ¶ 30,939, 57 Fed. Reg. 13,267 (1992) (to be codified at 18 C.F.R. pt. 284), *order on reh'g*, Order No. 636-A, F.E.R.C. STATS. & REGS. ¶ 30,950 (1992), *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶ 61,272 (1992), *reh'g denied*, 62 F.E.R.C. ¶ 61,007 (1993).

53. FPC v. La. Power & Light Co., 406 U.S. 621, 646–47 (1972).

54. *See* Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (D.C. Cir. 2000) (cited for the proposition that generic contract modifications may be appropriate).

55. 16 U.S.C. § 824e (2000).

56. Gulf Oil Corp. v. FPC, 563 F.2d 588, 606–08 (3rd Cir. 1977).

electricity crisis.[57] In fact, even before the disgorgement remedy was adopted under the Market Behavior Rules, the FERC remedied tariff violations by requiring that a seller disgorge its profits. For example, in *Washington Water Power Co.*,[58] the FERC ordered that a utility disgorge its profits for violating a tariff's posting requirements and giving undue preference to a marketing affiliate.

Responding to the FERC's assertion that it does not have authority to order refunds retroactively based on violations of market-based tariffs, the Ninth Circuit stated that the "FERC misapprehends its legal authority" and "possesses broad remedial authority to address anti-competitive behavior."[59] The court further stated that "our statutory construction of [the] FERC's authority is dictated by the plain language and words of the [FPA], and by a common sense application of the principles underlying the FPA," and the "FERC's construed limitations on its own authority are not supported by a careful examination of the FPA."[60]

The court continued as follows:

> [T]he power to order retroactive refunds when a company's non-compliance has been so egregious that it eviscerates the tariff is inherent in FERC's authority to approve a market-based tariff in the first instance. . . . [I]f no retroactive refunds were legally available, then the refund mechanism under a market-based tariff would be illusory. Parties aggrieved by the illegal rate would have no FERC remedy . . . . That result does not comport with the underlying theory or the regulatory structure established by the FPA.[61]

With respect to preventive measures, the FERC's Market Behavior Rules and the recently enacted rules for reporting changes in status are moves in the right direction. Diligent market monitoring by the FERC will also help to prevent market abuses and inform the FERC of where additional rules or structural changes may be needed. Moreover, the Energy Policy Act of 2005[62] gives the FERC additional rulemaking, enforcement, and civil penalty authority, which will help to prevent market manipulation. The threat of refunds is also a powerful preventive measure. By requiring refunds in the West, the FERC can provide both a remedy to past market misconduct, and a deterrent to future market misconduct.

VI. CONCLUSIONS

The basic tenets of the FPA are that electricity rates must be just and reasonable, and that the FERC has a duty to ensure that electricity rates are just and reasonable. In the emerging regulatory regime, the FERC retains a fundamental statutory duty to ensure just and reasonable rates, and this duty applies even as the FERC experiments with regulatory reform. Under market-based ratemaking, the FERC can ensure just and reasonable rates only by assuring competitive markets. Therefore, a valid presumption of the justness and reasonableness of MBRs, as reflected in contractual rates, depends on the

57. *See* California *ex rel.* Lockyer v. FERC, 383 F.3d 1006 (9th Cir. 2004).

58. *Washington Water Power Co.*, 83 F.E.R.C. ¶ 61,282 (1998).

59. *Lockyer*, 383 F.3d at 1015.

60. *Id.* at 1017.

61. *Lockyer*, 383 F.3d at 1016.

62. Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005).

existence of competitive markets at the time of contract formation. In effect, a FERC presumption that MBRs are just and reasonable creates a rebuttable presumption of competitive markets. If the presumption is successfully rebutted, then the presumptive finding of justness and reasonableness has no weight, and a legally sufficient first review of contractual rates, under a just and reasonable standard, should be required.

With market-based tariffs, when the presumption of competitive markets is successfully rebutted, the basic tenets of the FPA require a retrospective review of contractual rates to ensure that those rates are just and reasonable. This is true regardless of any contractual language to the contrary. Moreover, to the extent that any individual seller has violated the requirements of market-based tariffs, disgorgement of profits is an appropriate remedy.