No. 06-1457

IN THE

Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC.,
Petitioner,

v.

PUBLIC UTILITY DISTRICT NO. 1
OF SNOHOMISH COUNTY WASHINGTON, *et al.*,
and
FEDERAL ENERGY REGULATORY COMMISSION,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR PETITIONER

ERIC F. GROSSMAN
ZACHARY D. STERN
MORGAN STANLEY
CAPITAL GROUP INC.
1633 Broadway
New York, NY 10019

PAUL J. PANTANO, JR.
MICHAEL A. YUFFEE
MCDERMOTT WILL &
EMERY LLP
600 Thirteenth St., NW
Washington, DC 20005

WALTER DELLINGER
Counsel of Record
SRI SRINIVASAN
MARK S. DAVIES
O'MELVENY & MYERS LLP
1625 Eye St., NW
Washington, DC 20006
(202) 383-5300

Attorneys for Petitioner

QUESTION PRESENTED

Whether the Ninth Circuit erred by failing to abide by this Court's decisions in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956), and *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956), which—as the Federal Energy Regulatory Commission correctly decided—preclude the Commission from undoing a valid, bilaterally negotiated, arms-length wholesale energy contract that has, at most, a minimal impact on retail rates.

PARTIES TO THE PROCEEDING

Petitioner Morgan Stanley Capital Group Inc. intervened in the court of appeals.

Respondent Public Utility District No. 1 of Snohomish County Washington was the petitioner below.

Respondent Federal Energy Regulatory Commission was the respondent below and is respondent here "by rule." *See* Sup. Ct. Rule 12.6.

Respondent Mirant Americas Energy Marketing (now Mirant Energy Trading LLC) intervened in the court of appeals and is also a respondent by rule.

CORPORATE DISCLOSURE STATEMENT

Morgan Stanley Capital Group Inc. states that its parent company is Morgan Stanley. Based on Securities and Exchange Commission rules regarding beneficial ownership, State Street Bank & Trust Company, 225 Franklin Street, Boston, Massachusetts 02210, beneficially owned 12.1% of Morgan Stanley's stock on December 31, 2006 (based on a Schedule 13G filed on February 12, 2007 by State Street, acting in various fiduciary capacities).

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BRIEF FOR THE PETITIONER

DECISIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 471 F.3d 1053 and reprinted in the Appendix to the Petition ("Pet. App.")[1] at 1a-67a. The decision of the Administrative Law Judge is reported at 101 F.E.R.C. ¶ 63,031 and reprinted at Pet. App. 68a-245a. The opinion of the Federal Energy Regulatory Commission ("FERC") is reported at 103 F.E.R.C. ¶ 61,353 and reprinted at Pet. App. 246a-313a and J.A. 1222a-1323a. A related court of appeals decision is reported at 474 F.3d 587 and reprinted at Pet. App. 314a-330a.

JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on December 19, 2006. On March 8, 2007, Justice Kennedy signed an order extending the time for filing the petition for certiorari to and including May 3, 2007. The petition was filed on May 3, 2007, and was granted on September 25, 2007. This Court has jurisdiction under 28 U.S.C. § 1254(1).

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[1] Citations to "Pet. App." herein refer to the Appendix filed by petitioner in No. 06-1457. Citations to "J.A." herein refer to the Consolidated Joint Appendix filed in Nos. 06-1457 and 06-1462.

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Federal Power Act ("FPA" or "Act"), 16 U.S.C. § 791 *et seq.*, are reproduced at Pet. App. 331a-343a and J.A. 1615a-1623a. The key provision is Section 206(a) of the FPA, codified at 16 U.S.C. § 824e(a), concerning the authority of FERC to fix rates and other terms. The provision states in relevant part:

> Whenever the Commission, after a hearing held upon its own motion or upon complaint, shall find that any rate, charge, or classification, demanded, observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

STATEMENT

This case concerns a contract between petitioner Morgan Stanley Capital Group Inc. ("Morgan Stanley") and respondent Public Utility District No. 1 of Snohomish County Washington ("Snohomish"), one of the largest publicly owned utilities in the country. The agreement was entered into in the midst of the 2000-2001 crisis in energy markets in the Western States, when prices in the short-term or "spot" market for energy in California and neighboring States were at historically high levels. Rather than paying the high rates and remaining exposed to the day-to-day volatility of the spot market, Snohomish solicited and entered into an agreement with petitioner to purchase wholesale electricity for an extended period (105 months) at a fixed rate of less than one-third of the prevailing spot market rate.

The effect of that long-term agreement was to provide Snohomish stability in its energy costs, to insulate it from future increases in energy rates, and, at least at the outset, to save Snohomish a significant amount of money. Indeed, during the early months of the agreement, Snohomish did not even distribute all the power that it had purchased from Morgan Stanley and others to its retail customers—it sold some of the power back on the spot market, making $17 million in the process. Market conditions changed, however, and market prices subsequently fell below the rate that Snohomish had agreed to pay in its contract with petitioner. Snohomish, instead of continuing to abide by the terms of the contract, then filed a complaint with FERC seeking to set aside the contract on the basis that it is "unjust" and "unreasonable." 16 U.S.C. § 824e.

The question in this case is whether FERC was correct when it determined that it should not set aside the contract between petitioner and Snohomish. The answer is yes; FERC's judgment was correct. In *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956), and *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956), this Court established that FERC's authority to alter the wholesale energy rates paid by a public utility is highly limited where, as here, the rate is set by a contract. The Court recognized the special need to preserve contract stability in energy markets and established that wholesale energy contracts are not to be set aside except in situations involving an unequivocal public necessity. Not only is that standard plainly unsatisfied here, but the parties specifically set forth in their agreement that the contract rates were binding for the full duration of the contract and were not subject to adjustment through unilateral application to FERC. The Ninth Circuit nonetheless concluded that the contract is subject to revision by FERC. That decision is contrary to this Court's decisions in *Mobile* and *Sierra* and, if sustained, would significantly compromise the stability and soundness of the market for wholesale energy. The Ninth Circuit's decision should be overturned.

A. Statutory Background

1. For many years, the electric utility industry was dominated by "giant" vertically integrated holding companies that owned power generation, transmission, and distribution facilities.[2] After careful study, Congress concluded that federal regulation of the wholesale energy market was necessary. The congressional goal was to provide "Federal leadership" to "produce

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[2] *See* S. Rep. No. 74-621 (1935) (Senate Report to the Public Utility Act of 1935) ("Sen. Rep."). In *Public Utilities Commission of Rhode Island v. Attleboro Steam & Electric Co.*, 273 U.S. 83 (1927), this Court effectively ruled that states could not regulate these holding companies because they were engaged in interstate wholesale energy power sales.

an abundance of electricity at the lowest possible cost."[3]

Thus, in 1935, Congress enacted the Federal Power Act, 16 U.S.C. § 791a *et seq.* Before the FPA, the traditional "scheme of administrative rate setting at the federal level" had "called for rates to be set out by the regulated utility companies in proposed tariff schedules" and to be "accepted by the controlling agency so long as" they were "just and reasonable." *Verizon Commc'ns Inc. v. FCC*, 535 U.S. 467, 478 (2002). In the FPA, Congress "departed from the scheme of purely tariff-based regulation and acknowledged that contracts between commercial buyers and sellers could be used in ratesetting." *Id.* at 479; *see, e.g.*, 16 U.S.C. § 824(a).

2. The FPA gives FERC the authority to regulate the interstate transmission and sale of wholesale electricity. *See* 16 U.S.C. § 824. Under Section 205 of the FPA, all wholesale energy rates must be "just and reasonable," and any rate "that is not just and reasonable is * * * declared to be unlawful." *Id.* at § 824d(a). Section 205 provides that "[u]nder such rules and regulations as the Commission may prescribe," any wholesale seller "shall file" "within such time and in such form as the Commission may designate" its rates and charges as well as any contracts affecting its rates and charges. *Id.* at § 824d(c).

Section 206 of the FPA, 16 U.S.C. § 824e, defines the circumstances in which FERC can affirmatively set aside and adjust wholesale energy rates and contracts affecting such rates. FERC can take action un-

[3] Sen. Rep. at 17.

der Section 206 either on its own motion or in response to a complaint. *Id.* § 824e(a). If FERC determines that a wholesale energy rate or contract is "unjust, unreasonable, unduly discriminatory or preferential," FERC then must "determine the just and reasonable rate" or "contract" and "shall fix the same by order." *Id.*

3. In two unanimous decisions issued the same day (both per Justice Harlan), this Court long ago set the parameters of FERC's authority when rates are established by contract. *See United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956), and *Fed. Power Comm'n v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956). As explained further below, *Mobile* and *Sierra* hold that the terms of valid, bilaterally negotiated wholesale energy contracts are presumptively "just and reasonable," and that FERC has authority to set aside such contracts only in extraordinary circumstances involving unequivocal public necessity. *See Sierra*, 350 U.S. at 355.

The Court explained that, when a rate is set by contract, FERC cannot conclude "that the contract rate is unreasonable solely because it yields less than a fair return on the net invested capital." *Sierra*, 350 U.S. at 354-55. Even if FERC could not itself affirmatively "*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." *Id.* at 355. A contract therefore "may not be said to be either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility." *Id.* According to the Court, "preserving the integrity of contracts" and permitting modification of a contract only when "necessary in the public interest" affords "a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other." *Mobile*, 350 U.S. at 344.[4]

B. Regulatory Background

For many years, FERC assessed whether a rate was "just and reasonable" based upon the cost of providing service plus a fair return on invested capital. In the typical case, a vertically integrated power company would file a fixed-rate wholesale electricity tariff with FERC, and that rate would become the legal rate unless challenged. If FERC determined that the rate was not "just and reasonable" in view of the company's costs and reasonable profit, FERC would order refunds. *See generally* 18 C.F.R. § 154.1(b) (2007) (general obligation to file with FERC "schedules showing all rates and charges"); *Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1012 (9th Cir. 2004), *cert. denied*, 127 S. Ct. 2972 (2007).

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[4] Courts and agency materials often refer to two "standards of review," a "*Mobile-Sierra* public interest" standard and a "just and reasonable" standard. That terminology is intended as a short-hand means of distinguishing between FERC's limited authority under *Mobile* and *Sierra* to disturb rates set by private contracts and FERC's broader authority to revise non-contract rates. Both are applications, in different contexts, of a *single* over-arching statutory standard, *i.e.*, whether the contract or rate is "just and reasonable." 16 U.S.C. § 824e(a); *see* Pet. App. 9a n.7 ("The parties and some of the cases speak as if two alternative standards for reviewing wholesale electricity rates exist – the statutory 'just and reasonable' standard and the *Mobile-Sierra* public interest standard. We do not find this way of viewing the statutory terrain useful.").

In the late 1980s, "power marketers" began entering the wholesale energy market. Due to technical and legal changes not directly relevant here, power plants were built that were independent from the traditional vertically integrated utilities.[5] These independent producers sold power to, among others, "power marketers." Power marketers are entities that buy and sell wholesale power that they do not themselves generate (*i.e.*, entities that only "take title to electric energy"). *Citizens Power & Light Co.*, 48 F.E.R.C. ¶ 61,210, 61,776 n.7 (1989). FERC has concluded that power marketers "can increase efficiency in power supply markets and ultimately lower the cost of electricity." *Id.* at 61,776; *see id.* at 61,777 ("As a deal-maker and risk-taker, [a power marketer] will encourage exchange efficiency in electric power markets that otherwise might not be attained.").

FERC recognized that the traditional rate-filing methodologies would not work well for power marketers and other new types of entities. FERC found that the cost-based rate setting methodology used for traditional utilities makes no sense for a power marketer that has "no rate base on which to earn a traditional rate of return." *Citizens Power*, 48 F.E.R.C. at 61,777. Moreover, "pricing flexibility" "would undoubtedly permit [a power marketer] to respond quickly to changing market conditions and to be more effective." *Id.* Acting under its statutory authority to detail the "rules and regulations" about the "time" and "form" for filing of wholesale energy rates, *see* 16 U.S.C.

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[5] For an overview, see *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 681-82 (D.C. Cir. 2000) (describing "significant changes" to the industry since enactment of the FPA).

§ 824d(c), FERC enacted its "market based" rate regime.

Under FERC's market-based regulatory regime, a seller may obtain "market-based rate authority"—*i.e.*, approval to sell power at any rate a buyer is willing to pay—if the seller meets various conditions designed to guard against "the exercise of market power" and "self-dealing." *Citizens Power*, 48 F.E.R.C. at 61,777. Market power is defined as a seller's ability to "significantly influence price in the market by withholding service and excluding competitors for a significant period of time." *Id.* *See* Order No. 652, *Reporting Requirements for Changes in Status for Pub. Utils. with Market-Based Rate Auth.*, 110 F.E.R.C. ¶ 61,097, 2005 WL 327070, at *1-*2 (2005) (FERC engages in a "four part analysis" to assure a competitive market). The grant of market-based rate authority enables a seller to enter into agreements to sell wholesale power at market rates without having to submit each contract rate to the agency for review.

A seller's application for market-based rate authority is subject to public review and comment, and aggrieved parties may seek judicial review of the Commission's determination of market power (or lack thereof). FERC requires sellers to file periodic reports and updates upon any change in information relevant to the competitiveness inquiry. Power marketers, for example, typically filed applications updating their market power every three years. Order No. 652, 2005 WL 327070, at *3. The Commission retains broad authority to revoke a seller's market-based rate authorization if a seller fails to comply with these requirements or if market conditions change. *See* 16 U.S.C.

§ 824e(a); *e.g.*, *El Paso Elec. Co.*, 108 F.E.R.C. ¶ 61,071 (2004).[6]

FERC's market-based rate framework has led to a significant increase in wholesale energy production. By 2000, the Commission had granted market-based rate authority to nearly 900 entities.[7] As the Commission has observed, these nontraditional sources of power have "increase[d] the efficiency of the trading process for sellers and buyers" and "give[n] clear price signals indicating the best place and time to build new generation."[8] They have also "increased capital available to market participants" and "improved the industry's ability to address credit issues, increased the ability of companies to buy and sell energy, and increased market liquidity."[9]

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[6] For example, FERC revoked the market-based rate authority of various subsidiaries of Enron Corporation after finding that the entities engaged in market manipulation and failed to properly notify the Commission of increases in their market shares. *See, e.g.*, *El Paso Elec.*, 108 F.E.R.C. ¶ 61,071; *Enron Power Mktg., Inc. & Enron Energy Servs., Inc.*, 103 F.E.R.C. ¶ 61,343 (2003).

[7] *See* Energy Info. Admin., Office of Coal, Nuclear, Electric & Alternate Fuels, Dep't of Energy, *The Changing Structure of the Electric Power Industry 2000: An Update* at 63 (Oct. 2000), *available at* http://www.eia.doe.gov/cneaf/electricity/chg_stru_update/.

[8] *Id.*

[9] Office of Market Oversight & Investigations, FERC, *2004 State of the Markets Report* at 64 (June 2005), *available at* http://www.ferc.gov/EventCalendar/Files/20050615093455-06-15-05-som2004.pdf.

C. Factual Background

1. By the 1990s, the State of California had reduced its reliance on large energy holding companies to the point that it received one-third of its energy from non-traditional producers. In furtherance of those efforts, California enacted legislation requiring its public utilities to divest substantial amounts of electricity generation facilities. At the same time, California required the local utilities to sell power to, and purchase power, from the California Power Exchange Corporation ("CalPX"), a centralized market administering "spot market sales" (sales for services lasting 24 hours or less entered into the day of or day prior to delivery). Pet. App. 19a-20a, 23a.

In the summer of 2000, there was a "dramatic spike" in the price of wholesale electricity in the CalPX. Pet. App. 24a. The CalPX spot market price peaked at $1,099/MWh [megawatts/hour] on June 28, 2000, an amount that was a fifteen-fold increase over the historical average of $74/MWh. *Id.*

California "is part of a single integrated electricity market in the West." Pet. App. 25a. During the second half of 2000 and the first half of 2001, other Western energy markets also experienced high spot market prices. For instance, spot market prices in the Pacific Northwest reached an unprecedented $3,300/MWh in early December 2000. *Id.*

In November 2000, FERC issued an order identifying three causes of the spike in Western spot market prices. *San Diego Gas & Elec. Co.*, 93 F.E.R.C. ¶ 61,121 (2000). First, "competitive market forces played a major role," as production costs increased at the same time that demand increased due to unusually high temperatures and other market factors. *Id.* at 61,354. Second, the high prices were in part caused by "an over reliance on spot markets," as the CalPX rules at the time both discouraged reliance on long-term contracts and discouraged new entrants into the spot market. *Id.* at 61,359. Third, the Commission noted "clear evidence" that the structure of the California spot market afforded an "opportunity for sellers to exercise market power when supply is tight * * * . " *Id.* at 61,350. FERC concluded that an "essential remedy" was to move "significant amounts of wholesale transactions" from short-term spot markets to long-term "forward" contracts. *Id.* at 61,359.

2. On December 22, 2000, in the midst of the crises in Western spot markets, respondent Snohomish issued a request for proposals inviting petitioner Morgan Stanley and other entities to submit bids to supply wholesale energy. Pet. App. 162a. At that time, Snohomish was the second largest publicly-owned utility in Washington and the twelfth largest in the nation in terms of customers served.[10] *See* Snohomish County Pub. Util. Dist. No. 1 Annual Report 2001, at 14. Petitioner Morgan Stanley was one of the first entities approved by FERC to sell power at market prices, having first received market-based authority in 1994, *Morgan Stanley Capital Group, Inc.*, 69 F.E.R.C. ¶ 61,175 (Nov. 8, 1994), and having repeatedly been granted that authority thereafter, *e.g.*, *Morgan Stanley Capital*

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[10] Today, Snohomish is the largest publicly-owned utility in Washington, the second largest public utility in the Pacific Northwest, and remains the twelfth largest in the nation in terms of customers served. *Snohomish County PUD: About the PUD*, http: //www.snopud.com/about.

Group, Inc., No. ER94-1384-029 (June 26, 2001) (application filed November 8, 2000).

a. When Snohomish issued its request for proposals to Morgan Stanley and others, the spot market price for energy was "in excess" of $300/MWh.[11] Snohomish sought cheaper power and was willing to enter into a long-term arrangement to obtain it. Morgan Stanley's first proposal was to supply "power for periods of one, two or three years with gradually decreasing prices," one year at $290/MWh; two years at $206.75/MWh; or three years at $165.20/MWh. Pet. App. 163a; ER 859.[12] "Snohomish rejected this bid," and "specifically requested Morgan Stanley to bid 'for however many months' to permit Snohomish to purchase power for approximately $110/MWh." Pet. App. 163a-164a. For more than a week, Morgan Stanley and Snohomish engaged in extensive negotiations that included numerous conference calls and the exchange of multiple draft contracts. *Id.* at 165a. Snohomish repeatedly demanded that Morgan Stanley revise the price, quantity, and duration of its power supply offer. *Id.* at 164a-165a. As the negotiations progressed, Snohomish "informed Morgan Stanley that a price 'slightly over' $100/MWh, might be acceptable." *Id.* at 164a. Ultimately, "Morgan Stanley complied with Snohomish's request" and agreed to sell Snohomish 25 MWhs of "round-the-clock" energy at a price of $105/MWh for a period of 105 months (8.75 years). *Id.*

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[11] Ex. MSC-93 at 9:17-19, FERC Docket No. EL02-56 (Oct. 23, 2002).

[12] Citations to "ER" herein refer to the Joint Excerpts of Record filed in the United States Court of Appeals for the Ninth Circuit.

The contract was signed in late January 2001, and wholesale power deliveries started on April 1, 2001. Pet. App. 166a. Soon after Snohomish entered into the contract, it explained to its customers that its long-term contracts with Morgan Stanley and others "give us a lot of security against the uncertainty of market fluctuations," and insulated the ratepayers from market volatility. *Id.*

b. The contract contains two provisions that speak to FERC's authority under the FPA to adjust the contract terms. The first of those provisions is included in the "Western Systems Power Pool Agreement," an umbrella agreement setting out standardized terms for wholesale energy transactions. *See* Pet. App. 26a. That provision states that "[n]othing contained herein shall be construed as affecting in any way the right of the Parties to jointly make application to FERC for a change in the rates * * * terms, or conditions affecting * * * transactions under Section 205 of the [FPA]." *Id.* at 42a-43a. The purpose of that provision is to make clear the parties' intention that neither party acting alone can effect a change in the contract rates by filing a new rate under Section 205 of the FPA, but both parties acting together could do so. *See Mobile*, 350 U.S. at 343-44; *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Div.*, 358 U.S. 103, 112 (1958) (explaining that, while the default rule under *Mobile* is that neither party can unilaterally change a contract rate by filing a new rate under Section 205, the parties could specifically agree to preserve such unilateral authority); Pet. App. 37a-38a.

The second provision is not part of the standardized agreement, but is specific to the contract between Snohomish and Morgan Stanley. *See* Pet. App. 32a. That provision, entitled "Fixed Rates," states:

> The rates for service specified in this Agreement *shall remain in effect for the terms of this Agreement* and *shall not be subject to change through application to FERC* pursuant to the provisions of Section 205 or 206 of the Federal Power Act.

Id. at 194a (emphases added); J.A. 364a.

c. For the first several months of the agreement, prices in the wholesale spot market exceeded the contract rate, and Snohomish earned $17 million in profits by reselling power that it purchased under long-term contracts like this one. Pet. App. 218a-219a, 299a.[13] By late June 2001, however, prices in the Western energy spot markets had dropped. *Id.* at 115a, 252a. The market rates for short-term power fell below the rate established in the Morgan Stanley – Snohomish contract. On February 11, 2002, after only 10 months of the 105-month contract had elapsed, Snohomish filed with FERC a complaint against petitioner seeking to set aside the contract.

D. Agency Proceedings

1. Snohomish's complaint invoked FERC's authority under Section 206 of the Federal Power Act, notwithstanding the parties' agreement in the Fixed Rates provision of the contract that the rates "shall remain in effect" for the duration of the contract and

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[13] *See also* Ex. SNO-38, FERC Docket No. EL02-56 (Oct. 9, 2002); Hr'g Tr. vol. 21 at 1765, FERC Docket No. EL02-56 (Oct. 9, 2002); Hr'g Tr. vol. 23 at 2407-10, FERC Docket No. EL02-56 (Oct. 15, 2002).

"shall not be subject to change through application to FERC pursuant to the provisions of Section 205 or 206 of the [FPA]." Pet. App. 194a. The complaint challenged the "nearly nine year term" of the contract, claiming the contract "should be terminated, or at least shortened to no more than one year." J.A. 401a. As grounds for that relief, the complaint alleged that market dysfunctions in the spot market for power rendered forward contracts like the one at issue here unjust and unreasonable. *E.g.*, *id.* at 388a-391a. Two similar complaints against power suppliers were filed by Nevada Power Company/Sierra Pacific Power Company ("Nevada Companies") and Southern California Water Company ("So Cal Water").[14]

FERC ordered an evidentiary hearing on Snohomish's complaint as well as the complaints of the Nevada Companies and So Cal Water.[15] FERC explained

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[14] The Nevada Companies filed separate complaints against Duke Energy Trading and Marketing, L.L.C., Morgan Stanley, Calpine Energy Services, L.P. ("Calpine"), Mirant Americas Energy Marketing, L.P. ("Mirant"), Reliant Energy Services, Inc., El Paso Merchant Energy, L.P., BP Energy Company, Enron Power Marketing, Inc., and Allegheny Energy Supply Company, L.L.C. ("Allegheny"). So Cal Water filed a complaint against Mirant. Pet. App. 69a. The contracts involving the Nevada Companies and Mirant are discussed in the brief filed by petitioners in No. 06-1462, consolidated with this case. Mirant and So Cal Water are respondents to this petition.

[15] A few weeks later, FERC ordered a similar hearing on complaints filed by the California Public Utilities Commission and the California Electricity Oversight Board. *Pub. Utils. Comm'n of the State of Cal.*, 99 F.E.R.C. ¶ 61,087 (2002). This Court has not ruled on the petitions for certiorari arising from the Ninth Circuit's disposition (on the same day as the decision here) of those complaints. *See* S. Ct. Nos. 06-1454 & 06-1468.

that "[t]hese complaints allege that dysfunctions in the California electricity spot markets caused long-term contracts negotiated in the bilateral markets in California, Washington and Nevada to be unjust and unreasonable, and seek the extraordinary remedy of contract modification." J.A. 1082a. "To ensure that the complainants have a full and fair opportunity to present their cases and that the Commission, in turn, has a complete record on which to base its ultimate decision," FERC set the cases for a trial-type evidentiary hearing before an administrative law judge. *Id.* at 1082a, 1107a.

In so doing, however, FERC stated that the complainants bore the "heavy" burden of "proving that modification of contracts is justified." J.A. 1082a. FERC explained:

> The Commission's long-standing policy, consistent with a substantial body of Supreme Court and other judicial precedent, has been to recognize the sanctity of contracts. Rarely has the Commission deviated from that policy * * * . Preservation of contracts has, if anything, become even more critical since the policy was first adopted. Competitive power markets simply cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty, including certainty that the Commission will not modify market-based contracts unless there are *extraordinary* circumstances.

Id. at 1099a. FERC set a "refund effective date"—*i.e.*, the date from which Snohomish would receive a refund from Morgan Stanley should FERC find the contract unlawful—of April 12, 2002. *Id.* at 1104a.

2. Following a seventeen-day hearing that included testimony by expert and fact witnesses, the presiding ALJ issued a decision declining to set aside the contracts. Pet. App. 68a-245a. The ALJ found that the contracts were the product of "bona fide arm's-length transactions between knowledgeable companies." *Id.* at 220a. The ALJ further concluded that Snohomish had "failed to establish that dysfunctions in California spot markets materially affected" forward markets in the region, *id.* at 117a, and that "the forward market was a well functioning market (functioning competitively and efficiently) during the period in question," *id.* at 122a. In addition, the ALJ explained that Snohomish's contract with Morgan Stanley had at most "a small impact on [Snohomish's] rates," accounting for "no more than five percent of Snohomish's current portfolio costs" and "only three percent" of its overall load. *Id.* at 219a. Finally, the ALJ explained that, because "[e]nergy merchants rely on forward contracts, in an industry with volatile markets, to provide stable and predictable cash flows," abrogation or modification of the contracts in this case "will harm credit and investor confidence by altering the perception of a formerly stable cash flow into an undependable, risky cash flow." *Id.* at 176a-77a.

The ALJ explained that, under this Court's decisions in *Mobile* and *Sierra*, FERC's authority to modify negotiated, bilateral contracts is confined to situations in which the party seeking modification satisfies the "public-interest" standard that is only available in "extreme circumstances." Pet. App. 209a. Because the contract had resulted from voluntary choices by sophisticated parties, had originated in a forward market that was functioning competitively and efficiently, and had little impact on retail rates, the ALJ found that Snohomish had not "overcome [its] high burden under the public-interest standard." *Id.* at 210a.

3. On June 26, 2003, after taking the unusual step of hearing argument, the Commission affirmed the ALJ's decision. Pet. App. 246a-313a. The Commission expressly approved the ALJ's factual findings concerning the formation of the contracts, agreeing that the record "clearly indicates that the challenged transactions were the result of Complainants' voluntary choices," and that there was "no evidence of unfairness, bad faith, or duress in the original negotiations." Pet. App. at 301a. The Commission also agreed that there was no evidence that the contract had an adverse effect on ratepayers. *See id.* at 296a ("Snohomish presented no evidence that its contract with Morgan Stanley adversely affected Snohomish or its ratepayers.").

The Commission rejected Snohomish's argument that the forward market pricing failed to reflect competitive choices. The Commission acknowledged the findings of a FERC Staff Report, issued after the ALJ's decision, which concluded that "spot market distortions flowed through to forward power prices, particularly those for contracts of a short-term nature, *i.e.*, one to two years time to delivery." Pet. App. at 292a. But, as the Commission explained, "[e]vidence of market manipulation merely suggests yet another cause of the spot market dysfunctions and the unjust and unreasonable rates in the spot markets." *Id.*

The Commission also emphasized the importance of avoiding post hoc invalidation of energy contracts.

"Once a party signs a *Mobile Sierra* contract, it cannot escape by later claiming that the rates were not just and reasonable when it signed the contract." J.A. 1503a. The Commission rejected Snohomish's argument that FERC has greater discretion to undo this contract because it has "not been previously reviewed and accepted for filing by the Commission." Pet. App. 265a. According to the Commission, the "need for prior Commission review in these circumstances was met when, after determining that the Respondents lacked market power or had taken steps to mitigate it, the Commission authorized all of the Respondents in this proceeding to make sales of power at market-based rates." *Id.*

The Commission rejected Snohomish's argument that it "should have another opportunity to argue that the [market-based] rate was not just and reasonable." The Commission explained that doing so "would create uncertainty in the market, as a party who suddenly finds that its deal has become uneconomical, can undo the terms to which it was contractually bound." J.A. 1505a. That, the Commission observed, "is precisely what the *Mobile-Sierra* doctrine was designed to avoid." *Id.*

E. Decision Below

Snohomish filed a petition for review with the United States Court of Appeals for the Ninth Circuit, and that court reversed. Pet. App. 3a-4a, 65a-67a. According to the Ninth Circuit, the *Mobile-Sierra* presumption that rates established by a contract are just and reasonable should apply only in "certain limited circumstances." *Id.* at 20a; *see also id.* at 7a (*Mobile* and *Sierra* applicable "*in certain circumstances*").

In particular, the court believed that "the *Mobile-Sierra* mode of review" applies only if, *inter alia*, FERC has "an opportunity for initial review of the contracted rate." Pet. App. 39a. The court further concluded that "*Mobile-Sierra* cannot apply without a determination that the challenged contract was initially formed free from the influence of improper factors, such as market manipulation, the leverage of market power, or an otherwise dysfunctional market." *Id.* at 57a. The court also held that, even if the *Mobile-Sierra* framework were applicable and the question therefore were whether setting aside the contract is necessary in the public interest, FERC had erred in applying that standard. In the court of appeals' view, rather than assessing "whether the contracted rates pose an 'excessive burden,'" FERC should have ascertained "whether the wholesale energy contract is outside the 'zone of reasonableness' and results in retail rights higher than would be the case if that zone were not exceeded." *Id.* at 65a.

The panel therefore remanded the matter to FERC for it to "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." Pet. App. 66a.

SUMMARY OF ARGUMENT

1. a. In the landmark cases of *Mobile* and *Sierra*, this Court established that the terms of a negotiated wholesale energy agreement are "just and reasonable" for purposes of the Federal Power Act except in instances of unequivocal public necessity. The Court explained that Congress intends for ordinary contract-law principles to bind wholesale energy market participants, that contracts play a crucial role in advancing the Act's goals of affording an "abundance of electricity at the lowest possible cost," and that consumers ultimately benefit from holding sophisticated wholesale energy suppliers to their negotiated agreements. Each of those considerations is fully implicated in this case.

b. As FERC correctly concluded, the contract at issue here is not meaningfully different from the contracts enforced in *Mobile* and *Sierra*. In all three instances, the parties negotiated a long-term, fixed-price wholesale contract that, at the time of agreement, all parties believed would be in their economic interest. But subsequent market movements altered the parties' perceptions of the deal that they struck, and in each case the disappointed party asked FERC to void the contract—even though in all three instances the complaining party for a time had profited from the arrangement. In *Mobile* and *Sierra* this Court rejected that strategy and held that the contracts could not be set aside; the same result necessarily follows here.

c. The Ninth Circuit erred in attaching "preconditions" to the *Mobile-Sierra* presumption that the contract at issue is "just and reasonable." In the Ninth Circuit's view, the presumption that negotiated contracts are "just and reasonable" is inapplicable when contracts are entered into during a time of market "dysfunction." But parties necessarily negotiate a contract with imperfect information about future market conditions, and the very purpose of a fixed-price contract is to provide certainty to the purchaser. In numerous contexts, therefore, courts consistently hold that a contract to sell or buy at a fixed rate in the future is not invalidated merely because market conditions change in an unanticipated manner. And, in the context of a wholesale energy forward contract, it is particularly clear that the parties intend for the contract to govern despite market "dysfunction" because it is precisely the uncertainty of the spot market that is the reason for the forward agreement.

In this case, moreover, Snohomish was well aware of the "dysfunction" prior to entering this agreement. Indeed, the contract with Snohomish could not be clearer that it was intended to control in all future circumstances, stating expressly that it "shall remain in effect for the term of this Agreement." In fact, the volatile market conditions during 2000-2001 provide strong reason to uphold the contract here. In a volatile market, long-term, fixed-price agreements shelter a purchaser from future price changes. As more market participants enter into long-term agreements, market prices tend to return to normal levels. Thus, a key *solution* to periods of price volatility is forward contracts like this one. But if FERC has the authority to undo such contracts absent any public necessity, market solutions will not emerge to help solve future energy crises.

d. The Ninth Circuit also thought it important that FERC's regulatory regime permitted Morgan Stanley as an approved power marketer to enter into this wholesale power contract without requiring that the contract be filed with FERC. But *Mobile* and *Sierra* are founded on respect for contract stability rather than on any administrative filing precondition. Contrary to the suggestion of the Ninth Circuit, FERC did not specifically "approve" the contracts at issue in *Mobile* and *Sierra* either. In *Sierra*, this Court reversed FERC's decision to set aside a contract rate merely because it "yields less than a fair return," and the Court made no suggestion that FERC could have set aside the rate on that basis if it had been filed first with the agency. Moreover, even assuming that the presumption of contract stability turns on some requirement of initial agency review, the "market based" rate regime put in place by FERC suffices.

2. FERC correctly concluded that there is no "unequivocal public necessity" requiring that the terms of this contract be set aside. In *Sierra*, this Court described the rare instances in which FERC may undo a valid contract, such as contract rates that "impair the financial ability of the public utility to continue its service." But, as FERC correctly concluded, such circumstances do not exist here. The contract resulted in, at most, a minimal impact on Snohomish consumer rates. Undoing the contract, moreover, would cause substantial adverse consequences for the entire wholesale energy market that now more than ever relies on the predictability secured by reliable contract enforcement.

The Ninth Circuit drew a distinction between a contract challenged for setting wholesale energy rates too high and a contract challenged for setting wholesale energy rates too low. But a narrow focus on the impact of wholesale rates on retail rates paid at a particular time by a particular set of consumers ignores the broader systemic concerns for contract stability that underlie *Mobile* and *Sierra*. Moreover, the Ninth Circuit's "zone of reasonableness" test for assessing whether public necessity warrants setting aside a contract would effectively render the existence of a binding contract immaterial. *Mobile* and *Sierra* are fundamentally inconsistent with that approach.

ARGUMENT

Morgan Stanley and Snohomish are sophisticated parties who negotiated a $200 million bilateral wholesale power agreement. Snohomish got exactly what it bargained for and there is no suggestion of duress, fraud or any other traditional basis for undoing a contract. Indeed, were market conditions to repeat the events of 2000-2001 during the remaining term of the contract, Snohomish again would reap the benefit for itself and its ratepayers of purchasing power at or below the spot market rate. Under the Federal Power Act, FERC may in certain rare instances undo even valid contracts when required by an unequivocal public necessity. FERC correctly concluded there were no such circumstances implicated here.

I. THE TERMS OF THE MORGAN STANLEY – SNOHOMISH CONTRACT ARE "JUST AND REASONABLE" ABSENT A SHOWING OF PUBLIC NECESSITY

Beginning with its decisions in *Mobile* and *Sierra*, this Court has consistently recognized the importance of contract integrity in the particular context of FERC's regulation of the wholesale energy market. *See Potomac Elec. Power Co. v. FERC*, 210 F.3d 403, 409 (D.C. Cir. 2000) ("The [C]ourt has repeatedly emphasized the importance of contractual stability in a number of cases involving the *Mobile-Sierra* doctrine."). Those decisions are fully applicable to the contract at issue here, and they establish a strong presumption that the terms of this contract are "just and reasonable."

A. Under *Mobile* And *Sierra*, The Terms Of A Wholesale Energy Contract Are "Just And Reasonable" Absent Extraordinary Circumstances Implicating An Unequivocal Public Necessity

1. In *Mobile*, a private cement company planned "to construct a cement plant in the city [of Mobile, Alabama] provided it could be assured a supply of gas at a sufficiently low rate." 350 U.S. at 336. The local company that distributed natural gas was able to so assure the cement company because the local distribution company and a natural gas company subject to regulation under the Natural Gas Act entered into a ten year arrangement under which the local distribution company would pay "a rate substantially lower than that for other gas furnished" by the regulated natural gas company. *Id.* Midway through the term of the contract, however, the regulated natural gas company "purported to increase the rate on gas for resale to [the cement company], a rate more closely approximating that for other gas furnished" by the natural gas company. *Id.* The natural gas company claimed that under the Natural Gas Act it was permitted to charge any reasonable rate that it filed with the Commission.[16]

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[16] *See* United Gas Petition for Writ of Certiorari at 14, No. 17 (1955) ("contracts constitute no impediment, but are subject to

This Court disagreed:

> In construing the Act, we should bear in mind that it evinces no purpose to abrogate private rate contracts as such. To the contrary, by requiring contracts to be filed with the Commission, the Act expressly recognizes that rates to particular customers may be set by individual contracts.

Id. at 338.[17] The Court thus rejected the argument that the Natural Gas Act includes a "filed-rate" procedure under which a regulated natural gas company can "initiate changes, in which event the Commission's only concern is with the reasonableness of the new rate." *Id*. at 340. The "rate-making powers of natural gas companies were to be no different from those they would possess in the absence of the Act: to establish ex parte, and change at will, the rates offered to prospective customers; or to fix by contract, and change only by mutual agreement, the rate agreed upon with a particular customer." *Id*. at 344.

Mobile expressly recognizes that contract stability plays a critical role in advancing the purposes of the Natural Gas Act.[18] "[P]reserving the integrity of con-

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change as any other rule"); United Gas Merits Br. at 14, No. 17 (1955) ("Congress intended the statutory regulation to replace every other device including contract provisions").

[17] "In this respect," the Court continued, "the Act is in marked contrast to the Interstate Commerce Act, which in effect precludes private rate agreements." *Mobile*, 350 U.S. at 338.

[18] Although *Mobile* arose under the Natural Gas Act and *Sierra* under the Federal Power Act, this Court expressly noted that the two energy regulatory schemes were substantively identical

tracts," the Court explained, "permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry." *Id.* at 344. The Court noted that the industrial use of natural gas frequently requires "substantial investments" which customers "would be unwilling to make without long-term commitments from the" power distributor, and the distributor cannot make such commitments "if its supply contracts are subject to unilateral change by the natural gas company whenever its interests so dictate." *Id.* The cement company "contract furnishes a case in point." *Id.*

Mobile did not squarely address the authority of the Commission to alter rates under Section 206 of the FPA. Instead, the case concerned whether one of the contracting parties could unilaterally file new rates. In a companion case issued on the same day, however, this Court explained the limited circumstances in which FERC can disturb private agreements under Section 206.[19]

2. In *Sierra*, this Court made clear that the Commission may not alter an energy rate set forth in a negotiated contract merely because the rate is no longer

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for relevant purposes. *See Mobile*, 350 U.S. at 346 ("virtually identical provisions") and *Sierra*, 350 U.S. at 353 (relevant provisions "in all material respects substantially identical").

[19] *Mobile* did affirm the lower court's holding that the rate could not be changed "merely because the [economic] return is low." *Mobile Gas Serv. Corp. v. Fed. Power Comm'n*, 215 F.2d 883, 889 (3d Cir. 1954) ("there seems no doubt but that the [] account represented important new business to Mobile and to United and that the long range price concession was made in order to obtain it").

to the advantage of one of the contracting parties. The agreement at issue was between Sierra Pacific Power Company, a distributor of power to residents in Nevada and California, and Pacific Gas and Electric Company ("PG&E"), a public utility subject to regulation under the FPA. "[I]ncreased postwar demands and consumer agitation for cheaper power" had led Sierra to negotiate with PG&E for additional power. *Sierra*, 350 U.S. at 351. At the same time, Sierra was "negotiating for power from other sources, including the Federal Bureau of Reclamation, which at the time had unused capacity at Shasta Dam." *Id.* at 352. "To forestall the potential competition, PG&E offered Sierra a 15-year contract for power at a special low rate, which offer Sierra finally accepted." *Id.* In particular, PG&E normally earned a 5.5% rate of return, but nonetheless agreed to provide power to Sierra for a 2.6% rate of return.

A few years into the agreement, "when power from Shasta Dam was no longer available to Sierra," PG&E sought to raise its rate of return to 4.8%. *Sierra*, 350 U.S. at 352. The Commission determined that the existing rate of return in the contract—2.6%—was "unreasonable" because it "'would produce a return of substantially less than the 4.75% resulting from the proposed rate, which is the minimum PG&E is willing to accept.'" *Id.* at 354. The Commission "fixed the proposed rate as the 'just and reasonable rate,' thereby" in the Commission's view "satisfying the requirements of [FPA] § 206(a)." *Id.*

This Court sharply disagreed, holding that the Commission lacked authority under Section 206 to change the contract rate. The Court explained that "a contract may not be said to be either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility." *Sierra*, 350 U.S. at 355. The Court held that, although "the Commission may not normally *impose* upon a public utility a rate which would produce less than a fair return, it does not follow that the public utility may not itself agree by contract to a rate affording less than a fair return or that, if it does so, it is entitled to be relieved of its improvident bargain." *Id.* In that situation, the Court prescribed, "the sole concern of the Commission" is "whether the rate is so low as to adversely affect the public interest." *Id.*

In subsequent decisions, the Court has explained that the Commission's limited authority to set aside a rate that "adversely affect[s] the public interest," *id.*, "contemplates abrogation of these agreements only in circumstances of *unequivocal public necessity*." *Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968) (emphasis added). Accordingly, the Commission "lacks affirmative authority, absent *extraordinary circumstances*, to 'abrogate existing contractual arrangements.'" *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 582 (1981) (emphasis added) (quoting *Permian Basin*, 390 U.S. at 820).

3. This Court's recent decision in *Verizon Communications Inc. v. FCC*, 535 U.S. 467, 476 (2002), reiterates the need to enforce contract integrity in the wholesale energy market. In *Verizon*, the Court observed that, in the FPA and the Natural Gas Act, Congress "acknowledged that contracts between commercial buyers and sellers could be used in rate setting." *Id.* at 479 (citing *Mobile* and *Sierra*). "In wholesale markets," the Court explained, "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 two of them." *Id.* "When commercial parties did avail themselves of rate agreements," the Court continued, "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." *Id.* The Court then reiterated that FERC may not undo a wholesale energy contract merely because it amounts to an "'improvident bargain'" for one of the parties. *Id.* at 479-80 (quoting *Sierra*, 350 U.S. at 355).

B. The *Mobile-Sierra* Framework Applies To The Morgan Stanley – Snohomish Contract

The Morgan Stanley – Snohomish contract is not materially distinct from the contracts at issue in *Mobile* and *Sierra*. In all three instances, a party entered into a long-term wholesale contract that, at the time of agreement, the party believed to be in its economic interest. In *Mobile*, the power company desired to gain the business of the cement factory. In *Sierra*, PG&E sought to avoid losing the business to a competitor. And here, Snohomish entered into a long-term agreement with Morgan Stanley because the spot prices were hundreds of dollars per MWh higher than longer term arrangements and because Snohomish understandably sought "security against the uncertainty of market fluctuations." Pet. App. 166a. In all three instances, the party profited from the arrangement for a time.

But once market conditions changed and the deal became, at least for the moment, less favorable, all three parties asked FERC to intercede. In *Mobile*, the power company sought unilaterally to raise rates because it thought it had the legal authority to do so. In *Sierra*, the power company sought to raise rates because the competitive threat had diminished. And here Snohomish seeks to undo the contract because it could purchase cheaper power elsewhere. In *Mobile* and *Sierra* this Court rejected that strategy, and the identical strategy cannot work for Snohomish here either.

Snohomish, moreover, is the archetype of the "sophisticated business" that "could be expected to negotiate a 'just and reasonable' rate" as this Court contemplated in *Verizon*. 535 U.S. at 479. Snohomish is one of the largest publicly owned utilities in the country. The Commission stated that the record "clearly indicates that the challenged transactions were the result of [Snohomish's] voluntary choices," and that there was "no evidence of unfairness, bad faith, or duress in the original negotiations." Pet. App. 301a. To the contrary, Snohomish had "dictated the deadlines to complete negotiations and several of the contract terms." *Id.* at 165a. Indeed, Snohomish rejected various offers and counteroffers by Morgan Stanley, and Morgan Stanley eventually "complied with Snohomish's request" for a price around $100 MWh. *Id.* at 164a. Thus, as the ALJ found, "these transactions were bona fide arm's-length transactions between knowledgeable companies." *Id.* at 220a.

Accordingly, under *Mobile*, *Sierra*, and *Verizon*, the terms of the Morgan Stanley – Snohomish contract are presumptively "just and reasonable" and may be set aside only if there is an unequivocal public necessity.

C. The Ninth Circuit Erred In Establishing Preconditions To The Treatment Of A Wholesale Energy Contract As Presumptively Just And Reasonable

The Ninth Circuit held that the strong presumption of *Mobile* and *Sierra* that a contract rate is just and reasonable applies only "*in certain circumstances*." Pet. App. 9a. In the Ninth Circuit's view, the presumption is contingent on satisfaction of two preconditions: (i) FERC's review must "permit consideration of the factors relevant to the propriety of the contract's formation," in particular, "whether the original negotiations occurred in a functional marketplace such that we may presume the contracted rates were originally just and reasonable," *id.* at 42a; and (ii) "the regulatory scheme in which the contracts are formed must provide FERC with an opportunity for initial review of the contracted rate," *id.* at 39a. That approach is seriously flawed.

1. The presumption that a wholesale energy contract is just and reasonable does not turn on a post hoc assessment of whether there was "dysfunction" in the market.

The Ninth Circuit held that the *Mobile-Sierra* presumption of contractual integrity "cannot apply without a determination that the challenged contract was initially formed free from the influence of improper factors, such as market manipulation, the leverage of market power, or an otherwise dysfunctional market." Pet. App. 57a. There is no basis for setting aside a contract based on an after-the-fact determination that market "dysfunction" may have existed at the time the contract was negotiated. *See generally*

Amicus Br. of Int'l Swaps & Derivatives Ass'n, Inc., *et al*.

a. Parties necessarily negotiate a contract with imperfect information about the state of the market, and the purpose of a fixed-price contract is to give the parties a measure of certainty on a going-forward basis. The possibility that market "dysfunction" or other factors may affect prices is a fact about the world that the parties take into account when negotiating a fixed-price contract. The seller assumes the risk that market prices will rise, and the buyer assumes the risk that market prices will fall. Indeed, the central lesson of *Mobile* and *Sierra* is that a party does not get relief from a contract simply if it turns out to be an "improvident bargain" in the sense that the party's expectations about market conditions turn out to have been erroneous. *Sierra*, 350 U.S. at 355.

Courts thus uniformly hold that a contract to sell or buy at a fixed rate in the future is not invalidated merely because market conditions change in an unanticipated manner. "[A] fixed-price contract is an explicit assignment of the risk of market price increases to the seller and the risk of market price decreases to the buyer * * * . If, as is also the case here, the buyer forecasts the market incorrectly and therefore finds himself locked into a disadvantageous contract, he has only himself to blame and so cannot shift the risk back to the seller by invoking impossibility or related doctrines." *N. Ind. Pub. Serv. Co. v. Carbon County Coal Co.*, 799 F.2d 265, 278 (7th Cir. 1986) (Posner, J.). Under the Uniform Commercial Code, for instance, "a rise or a collapse in the market" is not "in itself a justification" for excusing non-performance of a contract, "for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover." U.C.C. § 2-615(a); *accord* Restatement (Second) of Contracts § 261, comment b (1981) ("[t]he continuation of existing market conditions and of the financial situation of the parties are ordinarily not such assumptions" underlying a contract, "so that mere market shifts or financial inability do not usually effect discharge under the rule stated in this Section"); 27 Williston on Contracts § 70:5 (4th ed. 1990), at 212-18 (erroneous predictions about future events, such as "future economic swings" or "[f]lawed economic predictions," do not provide a basis for reformation or rescission).

The conclusion that the parties to a fixed-price contract incorporate the risk that market "dysfunction" may affect market prices is particularly warranted where, as here, the parties have reason to be aware of the alleged dysfunction. Snohomish's own complaint, for example, acknowledged that "[a]t the time this contract was entered into, the Commission had found [that] Western spot markets were dysfunctional" J.A. 389a. By November 2000, two months before the contract was signed, FERC had explicitly noted "clear evidence" that the structure of the California spot market afforded an "opportunity for sellers to exercise market power." *San Diego Gas*, 93 F.E.R.C. at 61,350.

Indeed, the problems in the spot market were precisely the *reason* that parties turned to forward contracts like the one at issue here. During the inevitable times of high energy price volatility, sensible regulatory policies encourage long-term contracts in the energy market: "[t]he forward market provides a contractual means by which buyers and sellers can lock in prices over an extended period, hedging and allocating risk to specialists willing and able to take on that risk." Pet. App. 121a-22a. Thus, FERC concluded that an "essential remedy" to the 2000-2001 energy crises was to move "significant amounts of wholesale transactions" from short-term spot markets to long-term "forward" contracts. *San Diego Gas*, 93 F.E.R.C. at 61,359. Accordingly, Snohomish explained to its customers that its long-term contracts "give us a lot security against the uncertainty of market fluctuations." Pet. App. 166a. Setting aside forward contracts based on allegations of market "dysfunction" therefore would have the effect of attacking a solution to such dysfunction. The result of denying certainty to forward contracts would be to further drive up prices in the forward market, thus limiting the availability of a market solution to dysfunction in spot markets, and perhaps ultimately eliminating the availability of that solution altogether.

Moreover, subjecting wholesale supply contracts to revision based on after-the-fact conclusions about market "dysfunction" would introduce substantial uncertainty in a market in which stability of contracts is of paramount importance. As the Court explained in *Mobile,* recognizing the integrity of contracts "permits the stability of supply arrangements which all agree is essential to the health of the * * * industry." 350 U.S. at 344. But "it would cast a pall over any future negotiations * * * if a seller always had to be concerned that the market in which it was participating in the moment might later be found to be 'dysfunctional' and contracts entered into during the period of dysfunction made subject to retroactive adjustment." Pet. App. 181a; *see id.* at 176a-77a (setting aside contracts would "harm credit and investor confidence by altering the perception of a formerly stable cash flow into an undependable, risky cash flow") (internal quotation marks omitted).

That is particularly the case for this industry because it is not at all clear when market "dysfunction" would be found to exist, or what degree of "dysfunction" would suffice to warrant setting aside a contract. Although the market conditions during 2000-2001 were extreme, the power (and other energy) markets always have had—and always will have—imbalances in supply and demand that result in sudden price changes.[20] That is in part because power is difficult to store, so inventory changes do not smooth out price changes.[21] Also, weather changes can have a dramatic effect on power prices, as weather can prompt sudden and unanticipated consumer demand for air conditioning or heat. And, because it can take years to build a power plant, planning must be done far in advance despite the fact that future demand and supply conditions are hard to predict. The upshot is that it would

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[20] For example, as we write this "spikes" in the oil market are leading to a "buying frenzy" of "contracts that give the right to buy at a predetermined price and date" even though some "said the market was vulnerable to a correction." Javier Blas, *Soaring Oil Sparks Rush To Tie Down Prices*, Financial Times, Nov. 6, 2007, at 17. *See generally* Daniel Gabaldon, et al., *Betting Big on Baseload*, Elec. J. (Aug. – Sept. 2006) (noting that gas prices "are extremely volatile and notoriously difficult to forecast" and also noting "staggering degree of uncertainty" in electric industry).

[21] *See* Edison Electric Institute, *Key Facts about the Electric Power Industry*, at 47, *available at* http://www.eei.org/industry_issues/industry_overview_and_statistics /nonnav_key_facts/KeyFacts_Web.pdf.

be impossible for contracting parties to know at the time that they enter into an agreement whether the terms they have carefully negotiated may be set aside in the future based on the existence of some manner of ill-defined "dysfunction" in the market.

Finally, even assuming that an after-the-fact determination of market "dysfunction" could ever warrant setting aside a contract, the ALJ found that "[t]he evidence in this case establishes that the forward market was a well functioning market (functioning competitively and efficiently) during the period in question." Pet. App. 122a. To be sure, the Commission acknowledged the statements in a Staff Report that "spot market distortions flowed through to forward power prices, particularly those for contracts of a short-term nature, i.e., one to two years time to delivery."[22] *Id.* at 292a. But that is not surprising, as prices in a forward market inevitably turn in some measure on expectations about future prices in the underlying spot market. *See id.* at 118a. That prices in the two markets may be correlated, however, in no way means that competitive failure in one market carries through to the other. *See id.* at 122a.

b. There is all the more reason in this case to avoid post hoc assessments of the sort contemplated by the Ninth Circuit because the parties specifically agreed

[22] FERC's Staff concluded that for contracts longer than four years, such as the Morgan Stanley – Snohomish contract, there was no statistically significant relationship (other than for one hub not used here) between the spot market prices and the forward market prices. *Final Report on Price Manipulation in Western Markets*, Docket No. PA02-2-000 (March 2003) (reprinted in the Supplemental Joint Appendix at 1sa-404sa) at 202sa-203sa.

that the contract terms would remain binding in all events and would not be subject to after-the-fact revision by application to FERC. In particular, in the Fixed Rate provision of the contract, the parties took the important additional step of providing that in this contract the rate "shall remain in effect for the term[] of this Agreement" and that the terms "shall not be subject to change through application to FERC pursuant to the provisions of Section 205 or 206 of the [FPA]." Pet. App. 194a, 258a n.30; *see* J.A. 364a. That provision reinforces that, from Morgan Stanley's perspective, its agreement to supply power at the agreed-upon terms was contingent on avoiding the very sort of uncertainty caused by Snohomish's bringing this action. Indeed, what Snohomish seeks to accomplish is precisely what the Fixed Rate provision forbids—*i.e.,* preventing the contract rate from "remain[ing] in effect for the term[] of [the] Agreement" "through application to FERC pursuant to the provisions of Section * * * 206 of the [FPA]." Pet. App. 194a, 258a n.30; J.A. 364a. In light of Snohomish's agreement to that provision, it cannot be considered "unjust" or "unreasonable" to hold Snohomish to the bargain it struck in the contract.

Snohomish seeks to sidestep the Fixed Rate provision by arguing that, even if the provision bars Snohomish from challenging the contract rate, it "permits Snohomish to challenge the *length* of its agreement." Br. in Opp. to Pet. for Cert., at 16 n.8. That reading is untenable. As the Commission explained, "the negotiated term is intricately linked to the contract rate." Pet. App. 267a. The entire purpose of the "Fixed Rate" provision was to ensure that the rate remains "fixed" for the duration of the agreement. It therefore makes no sense to decouple the rate from the term of the agreement. The reason Snohomish wishes to challenge the term of the contract is because it does not want to pay the rate for the full term. But that rate was set on the assumption that the below market rate of the early period could be offset by receiving an above market rate for later years. Any challenge to the term of the contract therefore necessarily is a challenge to the rate, and is equally barred by the Fixed Rate provision.

2. The filing of a contract with FERC is not a precondition to presuming that the contract is valid.

The Ninth Circuit held that "the *Mobile-Sierra* doctrine applies only if a newly-entered contract remains in effect *after* there is an opportunity for plenary, 'just and reasonable' agency review." Pet. App. 41a. The court noted that in "*Mobile* and *Sierra* the rates had been submitted to the agency previously under section 205 and allowed to remain in effect." *Id.* at 21a; *see also id.* at 41a (suggesting that "premise" of *Mobile* and *Sierra* is that "reasonableness continued throughout the term of the contract"). The court declined to presume that the contracts here included "just and reasonable" rates because the market-based "regulatory scheme in which the contracts are formed" did not similarly "provide FERC with an opportunity for initial review of the contracted rate." *Id.* at 21a. *See also id.* at 325a (refusing to apply *Mobile* and *Sierra* because FERC "did not give prior approval" to the filed contract).

a. *Mobile* and *Sierra* themselves demonstrate that initial FERC review of the contract rates is not a precondition to presuming that the contract is "just and reasonable." *Mobile* and *Sierra* do not turn in any way on FERC's initial review of rates. Rather, those decisions recognize that the Act respects the ordinary rules of contract, promotes the stability of supply arrangements by promoting the integrity of contractual agreements, and limits FERC's authority to revise contract rates to rare instances of exceptional public necessity. The *Mobile* and *Sierra* emphasis on privately negotiated rates and the need for contact stability extends to all wholesale energy contracts, whether or not subject to initial review by the agency.

Contrary to the suggestion of the Ninth Circuit, moreover, Pet. App. 325a, FERC did not "give prior approval" to initial contract rates in *Mobile* and *Sierra*. Although FERC had accepted the contract rates for filing, the law is clear that FERC's acceptance of rates for filing does not constitute substantive "approval" of the rates as just and reasonable. FERC's regulations—then and now—expressly state that the "acceptance for filing of any tariff, contract or part thereof does not constitute approval by the Commission." 18 C.F.R. § 154.6 (2006); 18 C.F.R. § 154.23 (1955) (same).[23]

Indeed, *Mobile* and *Sierra* by nature could not require that FERC first have engaged in a "plenary" form of "just and reasonable review." It would make no sense for FERC to conduct two "just and reason-

[23] The Commission's order in *Mobile* accepting the higher rate for filing is explicit: "Nothing contained in this order shall" "be construed as constituting approval by this Commission of any service, rate, charge, classification * * * in the above designated schedule." United Gas Petition for Writ of Certiorari at 3, No. 17 (1955).

able" inquiries, a "plenary" one when the "newly-entered" contract takes effect, and a subsequent one that, consistent with *Mobile* and *Sierra*, accounts for the fact that the rates were set by contract. Once FERC concludes that a rate is unjust and unreasonable, FERC must reform the rates. *See* 16 U.S.C. § 824d(a). Thus, under the Ninth Circuit's approach, FERC would be in the position of having to invalidate rates as unjust and unreasonable as part of its "plenary" review of the contract, even though FERC at that initial step would have attached no significance to the fact that the rates were established by contract. The fundamental point of *Mobile* and *Sierra*, however, is that rates established by contract demand distinct treatment.

The facts of *Sierra* illustrate the point. There, FERC concluded that the rate set forth in the contract was "unreasonable * * * because it yields less than a fair return on the net invested capital." 350 U.S. at 355. This Court explained that, while FERC might not impose "upon a public utility a rate which would produce less than a fair return," a seller who agrees to such a rate in a contract is not "entitled to be relieved of its improvident bargain." *Id.* The Court thus held that FERC must assess "whether the rate is so low as to adversely affect the public interest" instead of assessing merely whether the rate "yields less than a fair return." *Id.* Nothing in the Court's opinion suggests that FERC would have had authority to set aside the contract rate on the basis that it "yields less than a fair return" if FERC had only done so when the contract was first filed rather than some years later. Yet that would be the result of the Ninth Circuit's approach.

b. Even assuming, *arguendo*, that the applicability of *Mobile* and *Sierra* were contingent on some manner of initial agency review, FERC's grant and renewal of market-based rate authority would suffice. *Mobile* and *Sierra* are grounded in the understanding that, "[i]n wholesale markets, the party charging the rate and the party charged [are] sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them." *Verizon*, 535 U.S. at 479. FERC's market-based rate authorization process serves to reinforce that the parties "enjoy[] presumptively equal bargaining power." *Id.*

In particular, the object of that process is to assure that the seller and its affiliates lack market power or have taken adequate measures to mitigate any market power. *See, e.g.*, *Lockyer*, 383 F.3d at 1009; *Grand Council of the Crees v. FERC*, 198 F.3d 950, 953 (D.C. Cir. 2000). To that end, sellers must file periodic reports concerning their market transactions and must submit updates concerning any changes that bear on the competitiveness inquiry. *See Citizens Power*, 48 F.E.R.C. at 61,777; Order No. 652, 2005 WL 327070, at *3. In this case, Morgan Stanley's market-based rate authorization was renewed in June 2001, *see* pp. 12-13, *supra*, within three months of the contract's effective date. If market conditions change or if the seller fails to adhere to its reporting requirements, the Commission retains full authority to revoke the seller's market-based rate authorization. In addition, a purchaser that is of the view that it lacks "equal bargaining power" with a seller, *Verizon*, 535 U.S. at 479, can challenge FERC's grant of market-based rate authority *before* entering into a contract with the seller.

The Ninth Circuit concluded that FERC's process of market-based rate authorization is inadequate to trigger *Mobile* and *Sierra*. But requiring FERC to engage in a more intensive process encompassing initial approval of each market-based contract would undermine the market-based rate regime, the central purpose of which is to enable those sellers who are shown to lack market power (or to have mitigated market power) to negotiate agreements in the market without having to file each contract with the agency. *See* p. 9, *supra*. As the Commission explained, "if we were required to examine every long-term service agreement as if the seller was seeking new market-based authority, it would make the original grant of market-based authority * * * a pointless exercise of no value to anyone." Pet. App. 266a. *See id.* at 265a-266a ("The need for prior Commission review in these circumstances was met when, after determining that [Morgan Stanley and others] lacked market power or had taken steps to mitigate it, the Commission authorized [Morgan Stanley and others] to make sales of power at market-based rates. * * * The 'just and reasonable' standard of Section 205 of the FPA is satisfied by the Commission's determination that the utility * * * lacks market power or has taken sufficient steps to mitigate market power.") (footnotes omitted).

II. AS FERC CORRECTLY CONCLUDED, THERE IS NO UNEQUIVOCAL PUBLIC NECESSITY TO SET ASIDE THE MORGAN STANLEY – SNOHOMISH CONTRACT

In highly narrow circumstances, FERC can conclude that the "public interest" overcomes the ordinary presumption that the terms of a wholesale energy contract are "just and reasonable." That authority derives from Section 201 of the FPA, which declares that "the business of transmitting and selling electric energy for ultimate distribution to the public is affected with a public interest." 16 U.S.C. § 824. FERC correctly concluded that this case does not present the sort of extraordinary circumstances in which the "public interest" requires setting aside the terms of a wholesale energy contract.

A. The Morgan Stanley – Snohomish Contract Is Not Causing Extensive Damage To The Public

1. This Court in *Sierra*, in the course of holding that FERC may not void a wholesale energy contract based on a utility's after-the-fact unhappiness with an agreement, described the highly limited circumstances in which FERC may invalidate the terms of a wholesale energy contract. According to the Court:

> In such circumstances, 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.

350 U.S. at 355. In short, only if a contract would cause extraordinary damage to the public—akin to the closing of a public utility—can FERC void a valid energy contract. This Court subsequently described the standard as follows: "The regulatory system created by the Act is premised on contractual agreements voluntarily devised by the regulated companies; it contemplates abrogation of these agreements only in circumstances of *unequivocal public necessity*." *Permian Basin*, 390 U.S. at 822 (emphasis added) (citing *Mobile*); *see Arkansas Louisiana Gas*, 453 U.S. at 582 (Commission "lacks affirmative authority, absent extraordinary circumstances, to 'abrogate existing contractual arrangements'") (quoting *Permian Basin*, 390 U.S. at 820).

A contemporary example of FERC's authority to alter the terms of a contract based on public necessity is presented by *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000). As part of FERC's effort to require utilities to provide access to their transmission lines to anyone purchasing or selling electricity in the interstate market—*i.e.*, "open access" requirement or Orders 888 and 889—FERC "ruled that it was in the public interest to allow [utilities] to add stranded cost amendments to their contracts [*i.e.*, raise charges] if they could demonstrate, in accordance with Order 888, that they had a reasonable expectation of continued service." *Id.* at 709. The D.C. Circuit upheld the finding, explaining that "it would be against the public interest to require other customers or shareholders to bear those costs" that a utility incurred based on an expectation of providing power to a particular customer. *Id.* at 711. Thus, the D.C. Circuit was faced with a rare instance where contractual modification was necessary to preserve the parties' originally bargained for expectations in light of broad changes to the regulatory scheme.

2. As FERC correctly determined, there is no such unequivocal public necessity to set aside the terms of the Morgan Stanley – Snohomish contract. There is no immediate danger that utility services to the public will be cut off, and the contract does not otherwise impose an "excessive burden" of the kind contemplated by the Court in *Sierra*. 350 U.S. at 355. To the contrary, the ALJ found that the contracts at issue here had at most "a small impact on rates." Pet. App. 219a. The Morgan Stanley contract represented "no more than five percent of Snohomish's current portfolio costs" and "only three percent" of its overall load. *Id.* The Commission agreed that there was no evidence that the contract had an adverse effect on ratepayers. *See id.* at 296a ("Snohomish presented no evidence that its contract with Morgan Stanley adversely affected Snohomish or its ratepayers.").

From a broader perspective, moreover, the Morgan Stanley – Snohomish contract *advances* rather than detracts from the public's need for stable sources of energy supply. As FERC properly found, the contract at issue allowed Snohomish to protect itself against spot market fluctuations. If Morgan Stanley had declined to enter into any agreement with Snohomish (as would have been the case had it known that the contract could be undone by Snohomish despite its explicit agreement to the contrary) then Snohomish and other utilities, and ultimately their customers, would have been worse off. Indeed, modification of these contracts "would destroy investor confidence and threaten the viability of bilateral forward markets." Pet. App. 176a.

B. The Ninth Circuit Erred In Drawing A Distinction Between High-Rate And Low-Rate Cases

In the Ninth Circuit's view, this Court's description in *Sierra* of the circumstances in which the public interest might require setting aside the terms of a valid contract is inapplicable here, because *Sierra* involved a challenge by a seller asserting that the contract rate is too low, whereas this case involves a challenge by a purchaser alleging that the contract rate is too high. *See* Pet. App. 61a-63a. The Ninth Circuit acknowledged that, "[w]hen a customer has negotiated a low contract rate, FERC must meet a high burden before raising that rate." *Id.* at 62a. But when "the customer is complaining of a *high* rate," *id.*, the Ninth Circuit believed, the relevant question "is whether the wholesale energy contract is outside the 'zone of reasonableness' and results in retail rates higher than would be the case if that zone were not exceeded," *id.* at 65a.

Contrary to the view of the Ninth Circuit, there is no sound basis for drawing a divide of that sort between low-rate cases and high-rate cases. *Cf. Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.,* 127 S. Ct. 1069, 1076 (2007) (applying same legal test to predatory bidding claims and predatory pricing claims because "claims are analytically similar"). The Ninth Circuit's narrow focus on the rates paid by a particular set of consumers at a particular point in time overlooks the broader systemic interests that underpin *Mobile* and *Sierra.* Those decisions are grounded in the need to "preserv[e] the integrity of contracts," so as to "permit[] the stability of supply arrangements which all agree is essential." *Mobile*, 350 U.S. at 344. The systemic interest in contract stability is equally in issue in a high-rate challenge brought by buyers as in a low-rate challenge brought by sellers. Indeed, the Court, soon after it issued its decisions in *Mobile* and *Sierra*, explained that Congress not only sought to establish "that the public interest requires the protection of consumers from excessive prices," but also "manifest[ed] its concern for the legitimate interests of the * * * companies in whose financial stability the gas-consuming public has a vital stake." *Memphis Light, Gas & Water*, 358 U.S. at 113-14.

Moreover, the Ninth Circuit's prescription to assess whether rates fall outside a "zone of reasonableness" effectively renders the existence of a binding contract wholly immaterial. Assessing whether a rate is outside the "zone of reasonableness" is tantamount to assessing whether a rate is "just" and "reasonable," without any consideration given to the fact that the rate is the product of a negotiated contract between sophisticated business entities. That is flatly inconsistent with this Court's clear command in *Mobile* and *Sierra* that existence of a binding contract bears materially on the scope of FERC's authority to alter wholesale energy rates.

The Ninth Circuit's "zone of reasonableness" test, in the end, is nothing like the "unequivocal public necessity" standard prescribed by this Court's decisions. Indeed, permitting FERC to invalidate a contract in the name of the "public interest" when it accounts for no more than five percent of the utility's costs would amount to overturning *Mobile* and *Sierra*. If those circumstances suffice to undo a valid wholesale energy contract, then FERC essentially has carte blanche authority to set aside virtually any energy contract in the name of the "public interest." *Mobile* and *Sierra* are fundamentally inconsistent with that approach.

* * * * *

Those who market power know, as FERC correctly concluded, that there was absolutely nothing wrong with the long-term contract at issue in this case. The Commission expressly found that the "challenged transaction[] [was] the result of [respondent Snohomish's] voluntary choices," and that there is "no evidence of unfairness, bad faith, or duress in the original negotiations." Pet. App. 301a. Modification or nullification of this valid contract would have a serious and adverse impact on the liquidity of the forward energy markets, which would in turn have correspondingly adverse consequences for the ultimate consumers of power as well as other energy products. The public interest is best served by continued adherence to this Court's decisions in *Mobile* and *Sierra*.

CONCLUSION

For the foregoing reasons, the Ninth Circuit's decision should be reversed and the petition for review denied.

Respectfully submitted,

ERIC F. GROSSMAN
ZACHARY D. STERN
MORGAN STANLEY
CAPITAL GROUP INC.
1633 Broadway
New York, NY 10019

WALTER DELLINGER
Counsel of Record
SRI SRINIVASAN
MARK S. DAVIES
O'MELVENY & MYERS LLP
1625 Eye Street, NW
Washington, DC 20006
(202) 383-5300

PAUL J. PANTANO, JR.
MICHAEL A. YUFFEE
MCDERMOTT WILL & EMERY LLP
600 Thirteenth Street, NW
Washington, DC 20005

Attorneys for Petitioner Morgan Stanley

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