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No. 06-1457, 06-1462

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.*,
RESPONDENTS.

CALPINE ENERGY SERVICES, L.P., *ET AL.*,
PETITIONERS,
v.
PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY WASHINGTON, *ET AL.*,
RESPONDENTS.

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

BRIEF OF CORAL POWER, L.L.C., DYNEGY POWER MARKETING, INC., PPM ENERGY, INC., AND SEMPRA GENERATION AS *AMICI CURIAE* SUPPORTING PETITIONERS

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INTEREST OF AMICI[1]

Amici are wholesale electricity sellers with billions of dollars at stake in the outcome of this case. Like the petitioners in the case under review, *amici* entered long-term contracts that are unquestionably valid and enforceable under traditional contract principles and settled precedent. But in a companion case issued the same day, applying the legal holdings in this case, the Ninth Circuit held that the Federal Energy Regulatory Commission ("FERC") must evaluate *amici's* contracts anew and set them aside or modify them if FERC determines that the rates are, in the abstract, "unjust" or "unreasonable." *See Pub. Utils. Comm'n of Cal. v. FERC*, 474 F.3d 587 (9th Cir. 2006) ("*CPUC*").[2] Under the Ninth Circuit's rulings in this case and *CPUC*, contracting parties are not permitted to decide for themselves what the lawful, contracted rate will be—even where there are no overriding public interest concerns. *Amici* submit this brief to bring to this Court's attention additional facts and circumstances regarding the energy crisis of 2000–01 and the contracts at issue in *CPUC* that provide important context to the issues presented in this case and

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[1] Pursuant to Supreme Court Rule 37.6, *amici* disclose that Sempra Generation's counsel, Latham & Watkins LLP, which along with counsel for other *amici* authored this brief, also represents Mirant Energy Trading, LLC, as a respondent in support of petitioners. No person or entity other than the *amici* made a monetary contribution intended to fund the preparation or submission of this brief. Pursuant to Supreme Court Rule 37.3(a), *amici* state that all parties have consented to the submission of this brief and the appropriate consents are submitted herewith.

[2] *Amici* filed petitions for a writ of certiorari to review the *CPUC* decision. *See* Docket Nos. 06-1454, 1468 (pet'ns filed May 3, 2007). This Court has not yet ruled on those petitions.

highlight the errors in the Ninth Circuit's decision under review.

In the order vacated by the Ninth Circuit's *CPUC* decision, FERC found that the State of California, acting though the California Department of Water Resources ("CDWR"), was by far the largest single buyer of wholesale energy during the crisis. *Pub. Utils. Comm'n of Cal. v. Sellers of Long Term Contracts to the Cal. Dep't of Water Res.*, 103 FERC ¶ 61,354, at 62,417 ("*CPUC I*"), *reh'g denied*, 105 FERC ¶ 61,182 (2003). Just in its contracts with *amici* at issue in *CPUC*, CDWR agreed to purchase over $10 billion in electricity over the long term. California recognized that "its actions would affect market prices," *id.*, and effectively used its considerable bargaining power, "negotiat[ing] with the sellers on an individual basis" and "gain[ing] leverage with each agreement that it reached." *Id.* at 62,440. California's negotiators lauded these long-term contracts at the time as "'fair, negotiated, hard-fought deals'" where, "'frequently, sellers had to concede numerous points.'" *Id.* at 62,417 (citations omitted). CDWR achieved its goal of obtaining a contract portfolio with an average price of no more than $70 per megawatt-hour, which would cause no increase in retail rates. *Id.* at 62,415.

California promised in these contracts (indeed, insisted in some) that no contracting party would have the right unilaterally to change the contract rates based on later changes in market conditions. But when market prices fell, two of CDWR's sister agencies—the California Public Utilities Commission ("CPUC") and the California Electricity Oversight Board ("CEOB")—sought to do precisely that.

The facts surrounding the California contracts explain the intense interest that *amici* have in the outcome of this case and, as set forth in greater detail in this brief, help highlight the analytical defects in the Ninth Circuit's opinion under review. To provide necessary context, we offer the following brief summary about these *amici* and their contracts with California, drawn from FERC's order in the *CPUC* case:

Dynegy Power Marketing, Inc. ("Dynegy"):

Several years before the energy crisis, Dynegy purchased a number of generating facilities in California. Dynegy relied on spot market sales to cover its operating costs and recoup its investment. By the end of January 2001, however, two of the three investor-owned utilities ("IOUs") in California had publicly indicated that they intended to default on their obligations to pay suppliers for power purchased in California's centralized, bid-based spot markets. Dynegy was therefore faced with the dual threat of not being paid for its past sales—which totaled hundreds of millions of dollars—and uncertainty as to whether there would be any creditworthy buyer for future sales. Dynegy was therefore eager to enter into a long-term contract to minimize its risks. There was only one buyer, CDWR, which ultimately solicited 199 offers to supply long-term power. During negotiations, CDWR (negotiating on behalf of the State) repeatedly threatened to use California Governor Gray Davis and the media to ensure that Dynegy would sign a favorable deal. The day after the parties entered into a memorandum of understanding for a long-term deal, CDWR insisted on renegotiating the terms. CDWR also insisted that Dynegy sell the State a substantial amount of power on an interim basis at prices well below then-prevailing spot-market prices (which Dynegy in fact did). On March 2, 2001, the parties entered into a four-year contract with flexible volumes allowing CDWR to purchase as much as 1000 megawatts ("MW") in the first year and 2100 MW thereafter, while reducing its takes in off-peak periods. Although FERC's regulations do not require sellers with market-based rate authorization to file their individual contracts, Dynegy took the additional step of submitting its CDWR contract to FERC. FERC put the contract out for comment. After the CPUC and CEOB intervened but "rais[ed] no substantive issues," FERC accepted the contract for filing effective March 2001. *Dynegy Power Mktg., Inc.*, 95 FERC ¶ 61,371, at 62,401 (2001).

Sempra Generation:

In early February 2001, Sempra Generation (formerly known as Sempra Energy Resources) submitted three bids to CDWR for long-term supply. At the time, Sempra Generation did not participate in California's power markets. Because it would take time to build the necessary generating facilities, Sempra Generation proposed to commence limited sales in 2002 as a power marketer, with increased sales in 2003 as its new generating facilities became operational. But CDWR's negotiators demanded that Sempra Generation provide power starting in 2001 if it wanted to reach any deal. Sempra Generation agreed. It bought power at an average price of $302.60 per megawatt-hour ("MWh") for June and $359.22/MWh for July through September, which it then sold to CDWR at a predetermined price of $177.91/MWh. As negotiations continued, CDWR repeatedly demanded and received further concessions from Sempra Generation.

Anticipating that it might enter into a contract with CDWR, Sempra Generation applied to FERC in February 2001 for authority to make sales at market-based rates. No party challenged Sempra Generation's application, which was granted on April 10, 2001, just three weeks before the execution of the Sempra Generation/CDWR contract on May 4, 2001. *See Sempra Energy Res.*, No. ER01-1178-000 (unreported letter order issued Apr. 10, 2001). Governor Davis praised the contract, which committed Sempra Generation to provide up to 1900 MW of power for approximately ten years. Sempra Generation in turn relied upon the revenue from the contract as a basis for investing over $1 billion in the development and construction of approximately 2300 MW of new generation in and around California.

Coral Power, L.L.C. ("Coral Power"):

In February 2001, CDWR approached Coral Power and proposed that the parties enter into a 10-year contract. But CDWR insisted that, to be eligible for a long-term contract, Coral Power must initially supply California with power in the short-term at below-market rates. Coral Power agreed, and as a result it lost a substantial amount in April and May 2001—with no guarantee that it would ever recover those losses under a long-term contract. CDWR repeatedly threatened to terminate discussions with Coral Power and exercised its bargaining leverage by demanding numerous concessions. On May 25, 2001, the parties finally executed an eleven-year contract providing the

State with 850 MW of power, including 225 MW from new generating facilities that Coral Power would construct in California. At the time, state representatives praised the contract as a good deal. 103 FERC ¶ 61,354, at 62,417.

PPM Energy, Inc. ("PPM"):

On June 19, 2001, FERC issued an order finding that its remedial actions begun in late 2000 had already had a "significant dampening effect on prices," *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 95 FERC ¶ 61,418, at 62,546 (2001) ("June 19 Order"), but it nonetheless took the additional step of extending price mitigation measures and generation must-offer requirements to all spot market sales in the Western United States. FERC later explained that its June 19 Order "adopted a prospective market monitoring and mitigation program to ensure that rates for spot sales throughout the Western United States remain just and reasonable." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 97 FERC ¶ 61,275, at 62,171 (2001). After the effective date of the June 19, 2001 Order, CDWR continued negotiations of a long-term power purchase agreement with PPM, agreed to extend their otherwise expiring memorandum of understanding, and demanded a number of concessions. On July 6, 2001, three weeks after FERC's implementation of the comprehensive mitigation measures adopted in the June 19, 2001 order, PPM and CDWR entered into a long-term power purchase agreement.

SUMMARY OF ARGUMENT

More than a half-century ago, this Court recognized that, in enacting the Federal Power Act ("FPA"), Congress built a workable regulatory structure upon a foundation of settled contract law principles. In the *Mobile* and *Sierra* decisions, the Court articulated a straightforward rule that has formed the basis for every wholesale electricity contract signed since. Simply put, contracting parties are free to determine for themselves what constitutes the just and reasonable rate, and parties can rely upon the fact that FERC lacks statutory authority to reform an existing contract except in rare circumstances of public necessity. That rule recognizes the importance of contract stability, which is critical to ensuring a reliable energy supply at a reasonable price, and at the same time gives FERC the opportunity to override a contract in extraordinary circumstances when necessary to protect consumer interests.

Lower courts applying the *Mobile-Sierra* doctrine have afforded FERC sufficient flexibility to discern and weigh the factors that affect the public interest, but they have resolutely forbidden FERC from undoing a valid contract simply because its rates, viewed in the abstract, appear unjust or unreasonable. The Ninth Circuit's decisions in this case and *CPUC* ignore that basic principle and subvert the settled expectations of all market participants. Departing from the holdings in *Mobile* and *Sierra*, and their progeny, the Ninth Circuit held that FERC may defer to the contracting parties determination as to what rates are "just and reasonable" only if the agency has already had the chance to conduct a "plenary, 'just and reasonable' agency review." *Morgan Stanley Capital*

Group Inc. v. Pub. Util. Dist. No. 1, No. 06-1457, Appendix ("Pet. App.") at 41a.

The Ninth Circuit's modified version of *Mobile-Sierra* turns the doctrine on its head, replacing reliance on consensual private agreements with faith in a government bureaucracy's regulatory prowess. Whereas *Mobile* and *Sierra* limit FERC's interference with private contracts to rare circumstances of unequivocal public necessity, under the Ninth Circuit's view *every* contract rate remains subject to revision unless and until it has been subject to plenary agency review. That reading is fundamentally inconsistent with the FPA's respect for traditional contract principles, and the discretion (if not duty) it gives FERC to disrupt the settled expectations of contracting parties is assuredly not in the long-term public interest.

Even if some preliminary opportunity for FERC review were necessary before a contract rate could be presumed the lawful, "just and reasonable" rate, FERC's market-based regulatory program more than sufficed to meet any such requirement. The Ninth Circuit concluded otherwise only by imposing a standard of perfection that the statute has never required and that would make any market-based approach unworkable. The Ninth Circuit then compounded that error by requiring that FERC also undertake a retrospective review of the circumstances of contract formation, and consider indicia of "market dysfunction" that are apparent only in hindsight. Even if the Ninth Circuit had a coherent and economically rational concept of what "dysfunction" is and how it might be relevant, the notion of invalidating valid forward contracts based on later-identified market imperfections is the antithesis of *Mobile-Sierra*. By eliminating the certainty and stability that the *Mobile-Sierra* doctrine provides, the Ninth Circuit's rulings would devastate the Nation's electricity markets and inflict massive costs on consumers.

The Ninth Circuit's misguided construction of the "public interest" is also flatly inconsistent with the *Mobile-Sierra* doctrine and unequivocally bad news for long-term consumer interests. By inviting, indeed, mandating, abrogation of wholesale contracts whenever, in hindsight, they appear to be bad bargains for buyers and a lower rate would translate into lower retail rates for consumers, the Ninth Circuit's new rules would destabilize long-term power contracts, impede the development of energy markets, and stifle investment in new resources. The Ninth Circuit had no authority to displace FERC's (and the statute's) balanced, long-term view of the public interest with its own myopic focus on short-term consumer prices. But even setting aside the fact that the "public interest" question is plainly one for FERC to decide, as a matter of policy the Ninth Circuit's short-sighted approach will ultimately injure the very consumers the Ninth Circuit purports to be protecting.

ARGUMENT

I. THE FPA ALLOWS CONTRACTING PARTIES TO DETERMINE FOR THEMSELVES WHAT RATES ARE "JUST AND REASONABLE"

Privately negotiated contracts have always been crucial to a well-functioning electricity industry, as Congress fully recognized when it enacted sections 205 and 206 of the FPA in 1935. *See Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968) (Natural Gas Act, which is materially identical to FPA, is "premised upon a continuing system of private contracting"). Because electricity is not transmitted or sold on a one-size-fits-all basis, a uniform tariff regime—as was typical in other regulated industries—was simply unworkable for the energy industry. *See United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332, 338 (1956) (comparing the NGA's nearly identical regime to traditional tariff-based regulatory laws such as the Interstate Commerce Act). In addition, transactions for wholesale electricity are usually made between "sophisticated businesses enjoying presumptively equal bargaining power, which could be expected to negotiate a 'just and reasonable' rate as between the two of them." *Verizon Commc'ns, Inc. v. FCC*, 535 U.S. 467, 479 (2002). Thus, the FPA "expressly recognizes that rates to particular customers may be set by individual contracts," *Mobile*, 350 U.S. at 338, and FERC's "sole concern" under the statute is whether the contract is contrary to the public interest. *FPC v. Sierra Pac. Power Corp.*, 350 U.S. 348, 355 (1956).

Nothing in the text, structure, or purpose of the FPA suggests that FERC has the authority—much less the responsibility—to disturb traditional contract principles and decide for itself what rates are just and reasonable *as between the contracting parties*. To the contrary, it has been settled law for over 50 years that the Act "evinces no purpose to abrogate private rate contracts as such." *Mobile*, 350 U.S. at 338. FERC was granted limited oversight authority to disturb private contracts only in "extraordinary circumstances" of public necessity. *Ark. La. Gas Co. v. Hall*, 453 U.S. 571, 582 (1981). When a contract is valid pursuant to ordinary contract principles, FERC's only task under the FPA is to determine whether modifying the contract is necessary to protect the public interest.

The Ninth Circuit paid little heed to this Court's appreciation of the FPA's foundation in contract law, which it viewed as a quaint anachronism. It read the FPA to grant FERC the authority—and the concomitant responsibility—to decide for itself what "just and reasonable" means as to every contract entered, notwithstanding agreement between the contracting parties. It held that a contract rate may not be presumed lawful unless FERC first has the "opportunity for initial review of the contracted rate." Pet. App. at 54a; *see also CPUC*, 474 F.3d at 594 (citing Pet. App. 54a). In the Ninth Circuit's view, a contract rate is not enforceable as "just and reasonable" until FERC deems it to be so.

Based on that misreading of the statute, the Ninth Circuit transformed what had always been a strong presumption in favor of upholding wholesale power contracts into a novel form of regulatory estoppel that bars a party from challenging the rate to which it voluntarily agreed *if and only if* FERC first had a chance to measure the rate against some undefined, abstract notion of justness and reasonableness. Under the Ninth Circuit's holdings, parties must seek FERC's blessing of every contract before they can be assured that it will be enforced consistent with its terms, even when there is no doubt that the contract is valid under traditional contract principles and raises no overriding public interest concerns. That is an untenable reading of the statute and completely destroys the careful accommodation Congress reached between "contract stability on the one hand and public regulation on the other." *Mobile*, 350 U.S. at 344.

The Ninth Circuit's application of this holding to the facts of the *CPUC* case demonstrates the illogic of the Ninth Circuit's approach. FERC found that CDWR had agreed in each of the contracts that neither buyer nor seller would have the right unilaterally to change the rates based on later changes in market conditions. Indeed, with respect to Sempra Generation's contract, CDWR demanded inclusion of text stating expressly that the contract terms "'are "just" and "reasonable" within the meaning of the FPA and that changes in market conditions will not render such rates, terms, and conditions "unjust" or "unreasonable" for purposes of'" FPA § 206. *Cal. Elec. Oversight Bd. v. Sellers of Energy & Capacity*, 105 FERC ¶ 61,182, at 61,941 (2003) (citation omitted). On appeal, the California agencies did not challenge FERC's determination that these contracts invoked *Mobile-Sierra* protection. *See CPUC*, 474 F.3d at 594 ("Here, it is undisputed that the contracts at issue either explicitly call for *Mobile-Sierra* review or do not preclude it.").

According to the Ninth Circuit, however, it was not sufficient that the buyers and sellers agreed to bind themselves to the more stringent public interest standard to modify the contract rates. The Ninth Circuit held that *Mobile-Sierra* contract protections are not triggered unless FERC also had the opportunity to engage in initial, plenary review of each contract and deem it to be "just and reasonable." The court of appeals placed enormous weight on the fact that the contracts at issue in *Mobile* and *Sierra* were filed with the Commission and subject to notice and comment before they were permitted to take effect.

Pet. App. at 39a. But nowhere in those decisions did this Court suggest that the opportunity for initial, plenary agency review was a necessary precondition to the presumption that parties' freely negotiated rates are just and reasonable. Rather, the critical insight of *Mobile* and *Sierra* is that contracting parties can decide for themselves that the agreed-upon rate is the just and reasonable rate. *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Div.*, 358 U.S. 103, 112-13 (1958) (FERC and the courts must look to the terms of the contract to determine when and how contracting parties can seek a rate change.).

The Ninth Circuit's misunderstanding of these principles was manifest in its treatment of Dynegy's contract, which *was* filed for public inspection and comment—even though that step was not required under FERC's market-based rate regulations. According to the Ninth Circuit, that filing did not count, because FERC "explicitly noted that *accepting* the filing of the Dynegy contract did 'not constitute *approval*'" of the contract rates. *CPUC*, 474 F.3d at 595 (citation omitted) (emphasis added). The Ninth Circuit overlooked the fact that the Commission orders accepting the *Mobile* and *Sierra* contracts for filing contained nearly the identical language. *See Pac. Gas & Elec. Co.*, 7 FPC 832 (1948) ("Nothing contained in this order shall be construed as constituting approval by this Commission of any … rate …."); *United Gas Pipe Line Co.*, 5 FPC 770 (1946) (same). As several other courts of appeals have recognized, advance agency approval is simply not required in order for a contract to take effect and be presumed lawful. *See Boston Edison Co. v. FERC*, 233 F.3d 60, 65 (1st Cir. 2000); *Borough of Lansdale v. FPC*, 494 F.2d 1104, 1114 (D.C. Cir. 1974) (holding that the "regulatory force of a contract arises before, and survives in the absence of, the physical filing of the document"); *Compania de Gas de Nuevo Laredo, S.A. v. FERC*, 606 F.2d 1024, 1029 (D.C. Cir. 1979) (applying *Lansdale* where a utility "seek[s] to enforce, rather than to abrogate, the unfiled contract"); *see also Natural Gas Pipeline Co. of Am. v. Harrington*, 246 F.2d 915, 919 (5th Cir. 1957), *cert. denied*, 356 U.S. 957 (1958).

Because it misapprehended the principles underlying the *Mobile-Sierra* doctrine, the Ninth Circuit failed to appreciate the import of FERC's core factual findings. With respect to the contracts at issue both in this case and in *CPUC*, FERC found no "evidence of unfairness, bad faith, or duress," or any other basis in traditional contract law to undo valid contracts. Pet. App. at 301a; *CPUC I*, 103 FERC ¶ 61,354 at 62,418. It determined that "the contracts at issue were the result of choices voluntarily made" by the buyers. Pet. App. at 300a; *CPUC I*, 103 FERC ¶ 61,354 at 62,418. Consistent with this Court's instructions in *Mobile* and *Sierra*, all that was left for FERC to decide was whether there were extraordinary public interest concerns that should override the parties' agreement.

II. EVEN IF INITIAL REVIEW WERE A PREREQUISITE TO *MOBILE-SIERRA*, IT WAS SATISFIED HERE

In both this case and *CPUC*, the Ninth Circuit held that FERC erred in limiting its review to public interest concerns and traditional contract principles, because FERC must first have "an opportunity for plenary 'just and reasonable' agency review." Pet. App. at 41a; *see also CPUC*, 474 F.3d at 594. Even if this were correct, and FERC had to establish some preliminary method to review existing contract rates before the rate could be presumed a lawful, "just and reasonable" rate, FERC's market-based regulatory scheme satisfied that requirement.

As this Court has recognized, FERC has considerable latitude in deciding how to evaluate the justness and reasonableness of rates. *See, e.g.*, *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). FERC's approach need not be exact—it may "'make the pragmatic adjustments which may be called for by particular circumstances.'" *Permian Basin*, 390 U.S. at 777 (citation omitted). As the D.C. Circuit observed, FERC has always been permitted in appropriate circumstances to rely upon "[l]ong-range estimates" that are "admittedly imperfect," *Town of Norwood v. FERC*, 53 F.3d 377, 380 (D.C. Cir. 1995), and *prospective* relief fulfills the statute's objectives if the agency's prediction ultimately proves to be incorrect.

Historically, FERC took a command-and-control approach to monitoring rates in the electricity industry, consistent with the fact that most electricity was supplied by vertically integrated companies with monopoly power in their respective service areas. But the industry has since evolved toward a more competitive environment, *see New York v. FERC*, 535 U.S. 1, 7–10 (2002) (recounting the increase in competitive power supply since 1935), enabling FERC to adopt a market-based regulatory approach, which is equally effective and far more efficient. Any obligation that FERC had under FPA § 205 to ensure that contract rates are just and reasonable was satisfied by FERC's market-based regulatory framework.

At the time the challenged contracts were entered, FERC required wholesale sellers to demonstrate that they lacked market power before they were permitted to negotiate market-rate sales. A seller's application was subject to public review and comment, and aggrieved parties could seek judicial review of FERC's determination. Furthermore, sellers had to file quarterly transaction reports with FERC, notify FERC if there was a change in status, and resubmit an updated market-power analysis every three years. *See Citizens Power & Light Corp.*, 48 FERC ¶ 61,210, at 61,778 (1989); 18 C.F.R. § 35.37. And parties could always file a complaint under FPA § 206 challenging the basis for a seller's market-based rate authority *before* a contract was executed. *See, e.g.*, *Mont. Consumer Counsel v. PPL Mont., LLC*, 121 FERC ¶ 61,127 (2007) (FERC retains independent authority to order refunds if party prevails on appeal of FERC's rejection of party's challenge to FERC's initial grant of market-based rate authority).

The Ninth Circuit rejected these mechanisms as insufficient to ensure that market-based contract rates are just and reasonable, for two reasons: First, FERC's initial market power analysis may have "so atrophied" by the time that a challenged contract was executed that the "basis for assuming the rates established would be within the statutorily mandated 'just and reasonable' range" may have "evaporated." Pet. App. at 53a-54a. Second, FERC must permit "timely consideration of sudden market changes" and protect "purchasers victimized by the abuses of sellers or dysfunctional market conditions that FERC itself only notices in hindsight." Pet. App. at 56a; *CPUC*, 474 F.3d at 594 (citing Pet. App. at 56a). Neither of the

Ninth Circuit's reasons for rejecting the sufficiency of FERC's market-based approach withstand scrutiny.

A. Staleness

The Ninth Circuit's decisions suggest that, in the midst of the energy crisis, FERC sat idly by while wholesale buyers ignorant of "dysfunctional" spot market conditions were forced to agree to unconscionable forward contract rates. Nothing could be further from the truth. In August 2000, FERC began publicly investigating the increase in spot-market prices. *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 92 FERC ¶ 61,172 (2000). All of the challenged contracts in this case and in *CPUC* were entered after the initiation of FERC's investigation, after FERC Staff issued a report examining the causes of high spot prices, and after FERC issued an order in November 2000 proposing remedies to correct any problems in the spot market. *See* Pet. App. at 148a. In December 2000, FERC implemented several structural reforms in the California spot markets—imposing price caps, modifying the rules governing market operations, and eliminating the requirement that the large IOUs in California purchase all of their power from California's centralized, bid-based spot markets.[3] FERC's actions and the underlying market conditions were well known to everyone in the Western energy markets when these contracts were executed, as FERC found when dismissing the complaints. Nevertheless, none of the

[3] *See* FERC, *The Western Energy Crisis, the Enron Bankruptcy, and FERC's Response* at 3-4, *available at* http://www.ferc.gov/industries/electric/Indus-act/wec/chron/chronology.pdf.

buyers in these cases saw reason to challenge any of the seller's market-based rate authority, and none bargained for the contractual right unilaterally to dispute the fairness of their rates should market conditions change.

For example, Sempra Generation filed its application seeking market-based rate authority on February 6, 2001, along with all of the evidentiary support it needed to demonstrate that it lacked market power. Had California genuinely been concerned that, because of market dysfunction, a contract with Sempra Generation may not be just and reasonable, that would have been the time to raise the issue. But it raised no such protest then—even though CEOB had intervened in the proceeding. FERC granted Sempra Generation's request for market-based rate authority on April 10, and CDWR signed the contract *only three weeks later*. Nothing in the record supports the notion that market conditions changed so dramatically during that three week period that FERC's market power findings had grown stale. Pet. App. at 53a-54a; *CPUC*, 474 F.3d at 594. Certainly California has never made such a suggestion. California filed a complaint challenging the contract only when, months later, market prices fell and it came down with an acute case of buyer's remorse. But at that point, it was simply too late. *See* 16 U.S.C. § 825*l*(b) ("No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do.").

The Ninth Circuit's treatment of PPM's contract also highlights how far removed the court's analysis of FERC's regulatory scheme was from the uncontested record facts. By the time CDWR entered its contract with PPM, FERC had already imposed specific market mitigation measures in spot markets throughout the West and had instituted a must-offer requirement. *See* June 19 Order, 95 FERC ¶ 61,418. California's FERC complaints conceded that the June 19 Order corrected any structural problems in the spot markets. And the State did not deny that CDWR extended an otherwise expiring memorandum of understanding in order to continue negotiations past June 19, receiving numerous concessions from PPM and then executed the PPM contract after June 19. Nonetheless, the Ninth Circuit vacated FERC's dismissal of the complaint against PPM, instructing FERC to consider on remand "whether some market dysfunction may have lingered" after the June 19 Order took effect, a theory not supported by any party's evidence at the time of FERC's dismissal of the complaint as to PPM. To justify its decision, the Ninth Circuit pointed to (and misinterpreted) a staff report that was published in March 2003—*almost a year after* FERC dismissed the complaint against PPM.

In sum, if California or anyone else believed that, because of spot market "dysfunction," the long-term contracts they might enter into were unjust and unreasonable, they had ample opportunity to say so. Upon a seller's application for market-based rate authority or at any point *before* entering into contracts with a seller, a buyer (or any other interested party) could have filed a complaint with FERC under FPA § 206 challenging the seller's right to sell at market-based rates. Through such a complaint process, any of the buyers now before this Court could have asserted that the market could not be relied upon to produce just and reasonable rates or that a particular seller had accumulated market power. Had such a complaint been filed, the buyer could have preserved the right to seek retroactive reformation of any subsequently entered contracts.[4] Even if the Ninth Circuit were right in believing that an initial opportunity for agency review is a precondition to presuming a contract rate just and reasonable, FERC's market-based rate program provided the necessary protections.

B. After-the-fact claims of "dysfunction"

The Ninth Circuit's second justification for rejecting FERC's existing market-based regulatory scheme is equally without merit. The court held that, in order for a market-based scheme to satisfy FPA § 205, FERC must be able to provide relief for "purchasers victimized by the abuses of sellers or of dysfunctional market conditions that FERC itself only notices in hindsight." Pet. App. at 56a; *CPUC*, 474 F.3d at 594 (citing Pet. App. at 56a). In ruling that, because parties have imperfect knowledge of market conditions, they must be permitted retrospectively to challenge the bases for presuming their market-based rates just and reasonable, the Ninth Circuit ignored the fact that parties to cost-based contracts also act on predictions that ultimately prove to be flawed—as was the case in *Sierra*. *See* 350 U.S. at 354-55. But that has never been a basis to reform a wholesale power contract. *See, e.g., Town of Norwood v. FERC*, 587

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[4] Similarly, California or any other interested party could have filed a timely protest of Sempra Generation's *initial* application for market-based rate authority and thereby preserved FERC's authority to provide retroactive refunds. *See, e.g., Mont. Consumer Counsel*, 121 FERC ¶ 61,127 at ¶ 13.

F.2d 1306, 1312 (D.C. Cir. 1978) ("[P]arties may be required to live with their bargains as time passes and various projections about the future are proved correct or incorrect."); *Pub. Serv. Co. of N.M.*, 43 FERC ¶ 61,469, at 62,153 (1988) ("The volatility of oil and gas prices, often reflecting large and dramatic swings, is old news," and is the very reason a buyer will seek a long-term contract at a fixed rate in the first place.), *aff'd*, *San Diego Gas & Elec. Co. v. FERC*, 904 F.2d 727 (D.C. Cir. 1990). Allowing contract abrogation because hindsight reveals it may have been a bad deal for one of the parties is fundamentally at war with *Mobile-Sierra* and destroys the contractual certainty and predictability that is necessary to a well-functioning market.

The Ninth Circuit's treatment of the Dynegy contract—discussed above—underscores this point. If, as the Ninth Circuit concluded, *Mobile-Sierra* can be evaded merely by claiming that market information "was not nearly as fully known" when the contract was signed "as it is today," 474 F.3d at 595, then no contract can escape the Ninth Circuit's evisceration of contractual certainty. It is, of course, virtually always the case that market information becomes clearer with hindsight. In fact, parties enter into long-term contracts in large part to hedge the risk of imperfect information; that purpose is completely frustrated if these contracts can be set aside based on buyers' remorse. *See Town of Norwood*, 587 F.2d at 1312 ("[P]arties may be required to live with their bargains as time passes and various projections about the future are proved correct or incorrect.").

Contrary to the Ninth Circuit's view, the statutory command that FERC ensure that rates are just and reasonable does not condone, much less require, the Commission retroactively to abrogate valid contracts. As the D.C. Circuit has recognized, "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." *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870-71 (1993). And FERC's scheme of "reactive" and "forward-looking" remedies provides sufficient safeguards, *Interstate Natural Gas Ass'n of Am. v. FERC*, 285 F.3d 18, 34 (D.C. Cir. 2002), even when FERC's "sanguine predictions about market conduct turn out to be incorrect." *La. Energy & Power Auth. v. FERC*, 141 F.3d 364, 370-71 (D.C. Cir. 1998).

Even if FERC had authority to modify existing market-based rates upon proof that the market in which they were established was not workably competitive, the factors that the Ninth Circuit identifies as evidencing spot market "dysfunction" do not reveal any competitive failure in the forward market, and would not justify modifying the contracts in this case or in *CPUC* under any coherent legal theory. Certainly it cannot be said that the sellers in this case or in *CPUC* exerted unequal bargaining power. In fact, if there were any advantages at the negotiating table for the contracts at issue in *CPUC*, it belonged to California, not the sellers. As FERC found, CDWR was "essentially a single purchaser" and was "in a favorable bargaining position as a buyer of forward bilateral contracts because it was the largest, creditworthy bulk buyer in the State of California." *CPUC I*, 103 FERC ¶ 61,354, at 62,417. And CDWR extracted valuable concessions in the process, requiring sellers to assume substantial risks associated with transmission and fuel costs and to purchase electricity from spot markets (at a sizeable loss) while sellers constructed generation facilities to fulfill the contract requirements. *Id.*

The Ninth Circuit's suggestion that the long-term contract rates were improperly influenced by "factors exogenous to the forward market," Pet. App. at 59a; *see also CPUC*, 474 F.3d at 595, would, if viewed as justification for setting aside forward contracts, itself introduce dysfunction into the forward markets. Prices in a forward market *necessarily* reflect expectations about future spot market prices. In fact, if forward contract prices *did not* reflect such expectations—whether caused by the high demand for electricity, tight supply, or the likelihood that FERC would impose additional corrective measures—then the market would not have been functioning properly.

The buyers in this case (and in *CPUC*) can be said to have been "victims" of "dysfunction" with regard to their forward contracts only in the sense that they believe they made wrong predictive judgments about the market. But that is often the case, and it is never a basis for unilaterally reforming a valid contract. Parties *always* contract in the absence of perfect information. Contracts enable parties to hedge and allocate risks associated with that uncertainty. Here, the parties all recognized that, because of a confluence of many factors, spot market prices were unusually high. By reaching long-term agreements with the sellers, for example, California immediately lowered its costs and avoided the possibility that spot market prices would continue to rise. But, on the other side of that coin, it accepted the risk that market prices for electricity might decline below its contract rates in the future.

The Ninth Circuit's holding that retrospectively detected market "dysfunction" constitutes a new contract defense under the FPA is especially dangerous because it would permit FERC to modify contracts based on an impossibly vague standard. Countless "factors exogenous to the forward market" influence prices, and the Ninth Circuit made no effort to identify which factors would qualify as "dysfunction" and justify the abrogation or modification of contracts. As a result, parties would lose the primary benefits of certainty and security that contracts allow, and FERC would be left with nearly unbounded discretion to decide in hindsight what the "just" or "reasonable" outcome should be.

Allowing California to abrogate its contracts based on the supposed "dysfunction" in the spot markets would be a particularly twisted outcome, because the crisis in those markets was largely of California's own making. In 1996, the California legislature required the State's three large IOUs to divest most of their electric generating assets and sell their remaining output into centralized, bid-based spot markets created by the State. At the same time, the State forbid the IOUs from entering any long-term contracts that could have hedged them against spot market volatility. By contrast, the sellers were part of the solution—because of these long-term contracts, many sellers, including Coral, Sempra Generation, and PPM, built additional generation facilities to serve a State that was in dire need of additional supply. *See CPUC I*, 103 FERC ¶ 61,354, at 62,418 (explaining that CDWR sought long-term contracts "because California 'needed new energy in addition to getting existing energy in the [S]tate under contract,' and "understood that long-term contracts were 'one building block ... in solving the energy crisis'") (citations omitted) (alterations in the original).

By assailing the certainty and stability that contracts provide, the Ninth Circuit's prescription for post hoc review will, if not reversed, lead to disastrous impacts upon consumers. *See generally* Cambridge Energy Research Assocs., *California Power Crisis Aftershock: The Potential Modification of Western Power Contracts* (Apr. 2007). As FERC recognized, "[i]f the integrity of contracts is undermined … the market, the industry and ultimately the consumer would suffer." *Pub. Serv. Co. of N.M.*, 43 FERC ¶ 61,469, at 62,153. Sellers in the *CPUC* case made considerable investments in new generation facilities to supply California, relying upon the rates CDWR agreed to in the challenged contracts. If FERC is provided the discretion to undo those contracts, the uncertainty bred of this decision and the decision in *CPUC* will reduce available supply and increase the cost of capital necessary to support power markets. And those effects will be most pronounced when market conditions are tight and volatile—precisely when the benefits afforded by contracts are needed most.

III. THE NINTH CIRCUIT'S DISTORTED PUBLIC INTEREST STANDARD FOR HIGH-RATE CHALLENGES UNDERMINES THE GOALS OF THE FPA AND CONTRAVENES *MOBILE* AND *SIERRA*

The rule that this Court announced in *Mobile* and *Sierra*, which recognizes that FERC may upset contract rights and obligations only where necessary to protect the public interest and never simply because a contract may have become an improvident bargain, should apply regardless of whether it is the buyer or the seller who challenges the contract. Yet the Ninth Circuit applied the "public interest" standard asymmetrically, in a manner that provides sellers no greater protection than if there were no contract at all. That approach is inconsistent with the FPA, as interpreted by this Court for more than 50 years.

According to the Ninth Circuit, the public interest standard allows buyers to undo the terms of their voluntarily negotiated contracts whenever they can show that wholesale contract rates exceed the "just and reasonable range." Pet. App. at 64a; *see also CPUC*, 474 F.3d at 596. That approach improperly collapses the rigorous standard announced in *Mobile-Sierra* with the standard that applies to challenged rates in the absence of a valid contract. Under the Ninth Circuit's approach, sellers are forced into a "heads I win, tails you lose" scenario where they will be forced to justify contract rates under the amorphous "just and reasonable" standard whenever ensuing events make the contract no longer favorable to the buyer, while the seller will not be able to escape its unfavorable obligations unless it can show that the contract is antithetical to the public interest. Effectively, the best price a seller can achieve under such a system is the lower of cost or market determined in hindsight—a business model under which no seller can long profit, attract capital or survive.

While the Ninth Circuit argues that this result is consistent with the FPA's focus on consumer welfare, it assuredly is not. The court of appeals' myopic view of the public good cannot be reconciled with the recognized statutory goal of preserving contract stability, and it is by no means in the long-term interest of consumers. As this Court recognized in *Mobile*, "the stability of supply arrangements" is "essential to the health of the natural gas industry." 350 U.S. at 344. Under the lopsided standards employed by the Ninth Circuit, sellers would either refuse to enter long-term contracts or demand much higher rates to compensate them for the risk that their contracts may later be undone. These additional costs would ultimately be borne by the American consumer.

CONCLUSION

For the foregoing reasons, the Ninth Circuit's decision should be reversed and FERC's orders below should be reinstated and affirmed.

Respectfully submitted,

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