Nos. 06-1457 & 06-1462

IN THE

Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC.,
Petitioner,

AND

AMERICAN ELECTRIC POWER SERVICE CORP.
AND
ALLEGHENY ENERGY SUPPLY CO., LLC,
Petitioners,

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**

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

In three landmark decisions applying the Federal Power Act (FPA), 16 U.S.C. §§ 791a *et seq.*, this Court recognized that the massive investments needed to build and maintain infrastructure for the production and delivery of power require that parties in the wholesale energy market have confidence that agreements they enter into today will be binding in the future, even if one of the parties comes to conclude in hindsight that the original deal was an improvident one. *See United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.,* 350 U.S. 332 (1956); *Fed. Power Comm'n v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956); *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Div.*, 358 U.S. 103 (1958). Those decisions thus hold that when sophisticated parties enter into a valid wholesale energy contract, the rates negotiated by the parties are presumed to satisfy the statutory requirement that they be just and reasonable, *see* 16 U.S.C. § 824e(a), and will be overturned by the Federal Energy Regulatory Commission (FERC) only in very rare cases where that action is compelled by the public interest. For over fifty years, that framework—the *Mobile-Sierra* doctrine—has promoted the public interest by affording market participants with a high degree of certainty that their arm's-length contracts will be honored absent exceptional circumstances.

FERC correctly applied the *Mobile-Sierra* public interest standard to the wholesale energy contracts at issue in these cases, and correctly declined to set aside the agreements. FERC found that with respect to the contracts at issue there was no unfairness, duress, or bad faith in the negotiations giving rise to the contracts, and that the sellers engaged in no exercise of market power or any sort of manipulative practices specific to the contracts or in the forward markets generally. To the contrary, FERC determined that the buyers under these contracts are sophisticated purchasers who could have entered into alternative agreements, but made the voluntary choice to execute these contracts. Indeed, the contracts were profitable to them for a time, but market conditions later changed.

Respondents now seek to avoid the buyers' contractual obligations, and to that end, advance a series of arguments for denying application of the *Mobile-Sierra* framework to these contracts. As FERC correctly concluded, however, abrogating these contracts "would create uncertainty in the market" in "precisely" the way that the "*Mobile-Sierra* doctrine was designed to avoid." J.A. 1505a. In fact, respondents' arguments would have the perverse effect of denying enforcement of forward contracts like those at issue here in precisely the situation in which they are most needed. When spot market prices are highly volatile, as was true during the 2000-2001 western energy crisis that gave rise to these agreements, forward, fixed-price supply agreements serve to insulate market participants from the unpredictability of spot market transactions. Of course, the nature of a forward agreement is that, as market conditions fluctuate, each of the parties at some point may come to conclude that it made an improvident bargain. But that is no reason to set aside the contract, the entire purpose of which was to secure a stable supply of power at a stable price over the life of the contract. Respondents' arguments for setting aside these contracts therefore should be rejected, FERC's orders declining to modify the contracts should be sustained, and the Ninth Circuit's decisions vacating those orders should be reversed.

I. FERC CORRECTLY APPLIED THE *MOBILE-SIERRA* FRAMEWORK TO THE WHOLESALE CONTRACTS AT ISSUE

This Court established in *Mobile* and *Sierra* that rates for the supply of energy negotiated in contracts are presumed to be just and reasonable, and are subject to abrogation only in exceptional circumstances in which the public interest compels it. In contending that FERC erred in applying the *Mobile-Sierra* framework to the contracts in issue, respondents argue variously that: (i) in applying the *Mobile-Sierra* framework, FERC impermissibly departed from the FPA's just and reasonable requirement; (ii) the *Mobile-Sierra* public interest standard in any event could only apply when a seller challenges a contract rate rather than when a buyer does so; (iii) the *Mobile-Sierra* framework should not apply in the circumstances of these cases because the contracts were formed in a time of market dysfunction; and (iv) the *Mobile-Sierra* framework should not apply in the absence of an initial opportunity by FERC to assess whether the contract rate exceeds a "zone of reasonableness." Respondents are wrong at every turn.

A. FERC's Application Of The *Mobile-Sierra* Framework Was Not In Derogation Of The FPA's Just And Reasonable Requirement

Respondents argue as a threshold matter that FERC failed to assess the contract rates at issue under the test prescribed by § 206(a) of the FPA, 16 U.S.C. § 824e(a), which requires the agency to set aside any rate that it finds to be "unjust" or "unreasonable." *See*

Snohomish Br. 29-34; CPUC Br. 58-59. According to respondents, FERC instead "applied a different standard, the 'public interest' standard," which respondents characterize as "impos[ing] a much higher hurdle than the just and reasonable standard." Snohomish Br. 30. Because FERC in respondents' view applied a different test than the one prescribed by the statute, they contend that FERC's orders must be set aside. That argument is fundamentally flawed.

1. To the extent respondents assert that FERC, in applying the *Mobile-Sierra* public interest standard, invoked a "different standard" from the statutory requirement that rates be just and reasonable, respondents are mistaken. Snohomish Br. 30. The public interest standard is a particular *application of*—not a departure from—the FPA's just and reasonable requirement, one that governs in the specific context of rates established by contract. *See* FERC Br. 21-22.

Sierra speaks directly to the issue. The Court there recognized FERC's "power under § 206(a) to prescribe a change in contract rates" based on "a finding that the existing rate is 'unjust, unreasonable, unduly discriminatory or preferential.'" 350 U.S. at 353. The Court held, however, that FERC had erred in concluding that a rate set by contract "is unreasonable solely because it yields less than a fair return on the net invested capital." *Id.* at 355. While asking whether a rate "produce[s] less than a fair return" may be an appropriate application of the FPA's just and reasonable requirement in the case of a *non*-contract rate, the Court explained, it was an "erroneous standard" in the context of a contract-based rate. *Id.* at 354-55. In the latter situation, "the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest." *Id.* at 355; *accord Mobile*, 350 U.S. at 344 (describing FERC's authority to modify a contract rate only "when necessary in the public interest").

Applying the public interest standard to contract rates, the Court reasoned, "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. That framework, the Court explicitly recognized in *Mobile* and *Sierra*, will protect the reasonable expectation of parties that their supply contracts will be honored, and "preserving the integrity of contracts . . . permits the stability of supply arrangements which all agree is essential to the health of the . . . industry." *Id.*

The upshot is that the standard by which to assess whether a rate is "unjust" or "unreasonable" under § 206(a) depends on the source of the rate. In the traditional situation of a rate unilaterally proposed by a utility in a tariff schedule filed with the agency, the question whether the rate qualifies as just and reasonable turns on whether it yields "a fair return." *Sierra*, 350 U.S. at 355. But in the situation of a rate negotiated by the parties to a wholesale energy contract, the rate negotiated in the contract is presumed just and reasonable and the "sole" basis for finding it unjust or unreasonable is if it "adversely affect[s] the public interest." *Id.*; *see id.* (finding it "clear that a contract may not be said to be either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility").

2. Respondents argue that certain language used by FERC in its orders shows that FERC refused to ap-

ply the FPA's overarching just and reasonable standard. *See* Snohomish Br. 25, 29-34; CPUC Br. 17, 58-59. But regardless of any imprecision in the words used by FERC in certain portions of its orders, the agency ultimately applied the correct standard. In particular, it is undisputed that FERC applied the *Mobile-Sierra* public interest standard. *See, e.g.*, J.A. 1244a ("Thus, we conclude that Complainants must demonstrate that the contracts in question are contrary to the public interest in order to support modification of the contracts."). And it is indisputable that, under *Mobile* and *Sierra*, that standard is the proper means of assessing whether a rate set by contract must be set aside on the ground that it is unjust and unreasonable. Because FERC thus applied the correct statutory standard, respondents err in asserting that certain language in FERC's orders shows that the agency "declined to apply the statutory standard." Snohomish Br. 29.

Respondents misperceive the import of the language used by FERC in its orders. In the course of explaining that it would apply the public interest standard, FERC stated that it declined to apply the less demanding standard that would govern a *non*-contract rate, which FERC termed the "'just and reasonable' standard of review." J.A. 1275a; *see* J.A. 1567a. Respondents seize on that label to argue that FERC thereby declined to apply the statutory just and reasonable standard. But FERC plainly *did* apply the statutory standard—the public interest standard is the particular application of § 206(a)'s requirement to set aside unjust or unreasonable rates that applies when the rate is established by a negotiated contract. In describing the alternative standard it declined to apply, FERC used the "'just and reasonable' standard" label as a short-hand reference to the traditional, cost-based "fair return" test that would govern a *non*-contract rate. Many courts of appeals have used exactly the same short-hand terminology.[1] To be sure, that terminology is imprecise: considered in isolation, it might appear to suggest erroneously that the public interest standard is an alternative to (rather than an application of) the statutory standard. *See* MSCG Br. 7 n.4.

In short, FERC's use of an imprecise label—"'just and reasonable' standard"—to describe the standard it chose *not* to apply, cannot obscure that the standard FERC *did* apply—the public interest standard—was correct. And because FERC ultimately applied the correct standard under the statute, there could be no basis for "remand[ing] the case to FERC with instructions to apply the statutory standard." Snohomish Br. 31-32; *see, e.g.*, *Nat'l Labor Relations Bd. v. Wyman-Gordon Co.*, 394 U.S. 759, 766 n.6 (1969) ("To remand would be an idle and useless formality. [*SEC v. Chenery*, 318 U.S. 80 (1943)] does not require that we convert judicial review of agency action into a ping-pong game. . . . There is not the slightest uncertainty as to the outcome of [the] agency proceeding" [and thus it] "would be meaningless to remand"); *Guan v. INS*, 453 F.3d 129, 137 (2d Cir. 2006) ("It is a long-standing principle of administrative law that agency errors do not justify a remand when 'remand[ing] would be an

[1] *See, e.g.*, *Boston Edison Co. v. FERC*, 233 F.3d 60, 68 (1st Cir. 2000); *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 710 (D.C. Cir. 2000).

idle and useless formality.'") (quoting *Wyman-Gordon*, 394 U.S. at 766 n.6).[2]

B. The *Mobile-Sierra* Framework Applies To Claims By Both Buyers And Sellers

Respondents contend here, that even if the *Mobile-Sierra* public interest standard could be read as an application of the FPA's just and reasonable requirement, it could apply only to claims by a selling party that the contract rate is too low, not to claims by a buying party that the contract rate is too high. *See* Snohomish Br. 33-34; CPUC Br. 29-33. Nothing in this Court's decisions or the FPA supports—let alone compels—that asymmetric approach.

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[2] Respondents cite a number of this Court's decisions for the proposition that FERC "cannot in the name of contract stability, enforce contracts that are unjust and unreasonable." Snohomish Br. 51-55. That assertion attacks a straw man. We do not argue that FERC could require adherence to a contract rate even if the rate were unjust and unreasonable in violation of the FPA. The point instead is that *Mobile* and *Sierra*, in recognition of the need for contract stability, adopted a presumption that contract rates *satisfy* the FPA's just and reasonable requirement and may not be set aside except in circumstances of public necessity. Nothing in the decisions identified by respondents suggests to the contrary. Indeed, only one of the decisions addressed FERC's authority to abrogate contract rates at all; and in that case, the Court explicitly adhered to *Mobile* and *Sierra*, explaining that the Commission is "without authority to abrogate existing contract prices unless it first conclude[s] that they 'adversely affect the public interest.'" *Permian Basin Area Rate Cases*, 390 U.S. 747, 821 (1968); *see id.* at 822 (FPA "is premised on contractual agreements voluntarily devised by the [parties]," and "contemplates abrogation of these agreements only in circumstances of unequivocal public necessity") (citing *Mobile*).

To the contrary, the central insight animating *Mobile*, *Sierra*, and *Memphis* is the need to promote contract stability in wholesale energy markets in order to effectuate the FPA's mandate to protect the long-run interests of energy consumers. That principle is equally at stake no matter which party—buyer or seller—seeks to set aside a contract. As the Court explained in *Mobile*, "preserving the integrity of contracts . . . permits the stability of supply arrangements which all agree is essential." 350 U.S. at 344. Buyers and sellers alike depend on the "stability of supply arrangements"—buyers, to ensure a steady supply of power; and sellers, to ensure a steady stream of revenue to finance the substantial capital investments necessary to build production capacity or to secure a reliable supply of power for resale. *See id.* (explaining that parties to contracts are required to make "substantial investments" but "would be unwilling to" do so without "long-term commitments" that are enforceable); *Memphis*, 358 U.S. at 113-14 (explaining that "preserving the 'integrity' of private contractual arrangements" is essential to allow "procurement of the vast sums necessary for the maintenance and expansion of . . . systems through equity and debt financing"). Not surprisingly, in applying this Court's holdings in *Mobile*, *Sierra*, and *Memphis*, the courts of appeals have, without exception, held that the public interest standard applies regardless of whether a buyer is challenging a rate as too high or a seller is challenging a rate as too low.[3]

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[3] *See, e.g.*, *Boston Edison Co. v. FERC*, 856 F.2d 361, 372 (1st Cir. 1988) (it is "logically inferable" that purchasers, like utilities, "can make bargains which in hindsight prove improvident," and treating purchasers and utilities similarly "brings a certain sym-

In defending an approach that would give buyers alone broad authority to undo wholesale energy contracts, respondents, like the Ninth Circuit below, focus narrowly on a short-term interest in minimizing the energy bills of those end-consumers who receive power through a given contract. *See* CPUC Br. 29-32; Pet. App. 64a. The FPA, however, does not seek myopically to advance above all else the interests of a particular set of consumers at a particular point in time. Rather, the statute aims more broadly to promote a stable and efficient supply of energy to all consumers over the long run. *See, e.g.*, S. Rep. No. 74-621 (1935). Giving buyers alone the ability to set aside forward supply contracts like those in issue here would cause sellers to add substantial risk premiums to the contract price, or worse yet, to refrain from offering forward supply contracts at all. As FERC rightly found in this case, any short-lived reduction in energy bills enjoyed by the particular set of consumers subject to a given contract would be far outstripped by the overall costs to the system as a whole from denying sellers certainty in their supply agreements. *See* J.A. 1099a ("Competitive power markets simply cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty . . ."). And the latter costs, in the form of added risk premiums or diminished availability of forward supply contracts, would ultimately fall on all consumers. There accordingly is no basis for applying the *Mobile-Sierra* public interest standard—and the stability of contractual arrange-

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metry to the ratemaking process"); *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403 (D.C. Cir. 2000); *Ne. Utils. Serv. Co. v. FERC*, 993 F.2d 937 (1st Cir. 1993); *San Diego Gas & Elec. Co. v. FERC*, 904 F.2d 727 (D.C. Cir. 1990).

ments embodied by that standard—exclusively for the benefit of buyers rather than sellers.

This Court recognized as much in *Memphis*, observing, "[i]t seems plain that Congress . . . was not only expressing its conviction that the public interest requires the protection of consumers from excessive prices for natural gas, but was also manifesting its concern for the legitimate interests of natural gas companies in whose financial stability the gas-consuming public has a vital stake." 358 U.S. at 113. The Court held that a seller could raise its rates unilaterally by filing new rates with FERC because the seller had specifically negotiated for that unilateral entitlement in its contract. *Id.* at 112-14. That holding, by recognizing that sellers have the same entitlement as buyers to hold the other party to the terms of a supply contract, manifests the symmetry inherent in the FPA.

Of course, buyers could negotiate for a similar "*Memphis* clause" entitling them unilaterally to seek a reduction in contract rates with FERC beyond when the public interest would require it. The buyers in these cases, however, did not do so. The asymmetric approach that respondents advocate nonetheless would effectively grant them (and all buyers) the benefit of such a *Memphis* clause without any need to negotiate for it. Nothing in the FPA compels that anomalous result, which ultimately would have the self-defeating effect of *raising* the contract rates demanded by sellers as compensation for the *Memphis* clause that respondents would impute in favor of all buyers.[4]

C. There Is No Basis For Denying *Mobile-Sierra* Treatment On The Basis Of The Spot Market Dysfunctions That Gave Rise To These Forward Contracts

The Ninth Circuit opined, and respondents here argue, that the *Mobile-Sierra* presumption that a contract rate is just and reasonable is contingent on the existence of effective competition in the market at the time the contract was formed. Snohomish Br. 35-41; CPUC Br. 48-54; Pet. App. 41a-42a. Respondents contend that the *Mobile-Sierra* presumption is unwarranted because these forward contracts were executed when "the western energy markets in 2000-2001" were subject to "severe[] manipulat[ion]." Snohomish Br. 35.[5] Any market manipulation at work during that

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[4] Respondents not only failed to negotiate for a *Memphis* clause, but in one of the contracts at issue, respondent Snohomish embraced what amounts to an *anti-Memphis* clause under which it explicitly agreed to refrain from taking precisely the action that it took here, *viz.*, unilaterally seeking relief from the contract from FERC. *See* MSCG Br. 38-40. Respondents' approach perversely would give a buyer the benefit of a *Memphis* clause even in that situation—*i.e.*, when the buyer not only fails to negotiate for an entitlement to seek unilateral relief from the contract, but goes further and explicitly agrees to forego any such authority.

[5] *But see* S.J.A. 17sa (evidence of "significant [] manipulation" "does not alter the Commission's original conclusion, set forth in its December 15, 2000 Order, that significant supply shortfalls and a fatally flawed market design were the root causes of the California market meltdown"). Contrary to the suggestion of respondent Snohomish, *see* Snohomish Br. 10-11, FERC has never found that petitioners engaged in spot-market manipulation. Indeed, while FERC issued a general show-cause order against doz-

period in the California *spot* markets for electricity, however, should afford no basis for denying enforcement of contracts executed in the *forward* markets.

FERC assumed that, at the time these contracts were formed, the California spot markets were subject to market manipulation. *See* J.A. 1274a-1275a. But FERC found no indication of manipulative practices in the forward markets in which these contracts were negotiated, let alone any indication of manipulative practices in the forward markets by the sellers under the contracts at issue. Rather, FERC expressly found that "there has been no showing to support a finding that [sellers] exercised market power while selling under their market-based pricing authorization with regard to these specific contracts," J.A. 1512a, or any "evidence supporting a finding of market manipulation that specifically affected the contracts at issue." J.A. 1538a. *See* Pet. App. 59a ("local utilities do not allege that the energy companies manipulated their negotiations of the contracts here at issue"); *see also* J.A. 1285a, 1495a-1496a, 1516a, 1589a. FERC also found "no evidence of unfairness, bad faith, or duress in the original negotiations." J.A. 1285a; *see* J.A. 1496a. Accordingly, FERC concluded, "the contracts at issue were the result of choices voluntarily made by" re-

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ens of market participants as part of its investigation, FERC settled the show-cause orders against petitioners without any finding or admission of liability or wrongdoing. *See, e.g.*, *Morgan Stanley Capital Group*, 105 F.E.R.C. ¶ 63,028, 65,129 (2003); *Am. Elec. Power Serv. Corp.*, 105 F.E.R.C. ¶ 63,013 (2003).

spondents, who "had better alternatives and were not compelled to enter into the contracts." J.A. 1284a.[6]

Respondents, echoing the Ninth Circuit, emphasize that even if the forward markets were free of manipulation or other misconduct, anticompetitive conduct infected the adjacent spot markets. *See* Pet. App. 59a; CPUC Br. 48-50; Snohomish Br. 39. But the existence of manipulation in the spot markets does not justify setting aside contracts made in the forward markets.

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[6] Notwithstanding those unequivocal findings by FERC, respondent Snohomish asserts, Snohomish Br. 39, that FERC "ignored" evidence "that the forward markets were not effectively competitive." But in asserting that sellers in the forward market "exercise[ed] substantial market power," *id.* at 37, Snohomish relies entirely on the reports of respondents' own expert witnesses, whose testimony the administrative law judge declined to credit because of methodological flaws. *See* Pet. App. 128a-130a. Snohomish further asserts that "it had no options to resist sellers' exercise of market power," Snohomish Br. 37, when it entered into its contract with petitioner Morgan Stanley, and presents a highly one-sided and misleading account of the negotiations between the parties. *Id.* at 37-39. FERC, however, specifically rejected Snohomish's argument "that the evidentiary record contains evidence of duress and exercise of market power by Morgan Stanley," concluding that the "evidentiary record does not support Snohomish's allegations." J.A. 1591a; *see* J.A. 1584a-1585a; *id.* at 1591a-1592a (concluding that Snohomish—not Morgan Stanley—"dictated the deadlines to complete negotiations and several of the contract terms"). For instance, while Snohomish asserts "that Morgan Stanley knew that Snohomish was receiving fundamentally a 'bad deal,'" Snohomish Br. 38, the statement concerning a "bad deal" was made in the course of a hypothetical discussion about what would happen *if* the market moved down. Record No. 1198, Vol. 3, at 87-88 (speculating that, "[i]f it moves down," Snohomish would benefit "[o]verall" because of lower prices for future deals, but would "have one bad deal" because "they're stuck with just an out-of-the-money contract").

Denying enforcement of forward supply agreements based on manipulation or "dysfunction" in an adjacent spot market would unduly sacrifice the critical goal of contract stability underlying the *Mobile-Sierra* framework. Because sellers in the forward markets would have little ability to know whether those markets (or a related market) are in some way affected by manipulation or "dysfunction" in an adjacent spot market, respondents' approach would render the enforceability of forward supply agreements substantially unpredictable. That uncertainty would be magnified by the absence of clear guidance concerning the sorts of misconduct, the degree of misconduct, and the extent and nature of the nexus between the misconduct and a contract, that would be required to justify obtaining relief from the contract.

A central virtue of forward energy supply agreements is to secure certainty in the face of known and unknown risks so that parties can manage and mitigate those risks. These cases involve a "known unknown," in that the parties were specifically aware of the possibility that manipulative practices and "dysfunction" infected the California spot markets. By the time these contracts were negotiated, FERC had noted the "opportunity for sellers to exercise market power" in the California spot markets, *San Diego Gas & Electric Co.*, 93 F.E.R.C. ¶ 61,121, 61,350 (2000), and respondent Snohomish conceded in its complaint that, "[a]t the time this contract was entered into, the Commission had found [that] Western spot markets were dysfunctional." J.A. 389a. All parties to these contracts had access to that information about the markets, with sellers assuming the risk that market prices would fall and buyers assuming the risk that prices would rise. Given that an essential purpose of forward agreements is to enable the parties to allocate precisely those sorts of risks, it would make little sense to deny enforcement of such a contract on account of risks that the parties were free to take into account in their agreements.[7]

The integrity of forward supply contracts is particularly vital in periods of great volatility in spot markets. That is because forward agreements to supply power at a fixed price are a principal *antidote* to spot-market volatility. Indeed, a central cause of the crisis in the California spot markets was a set of market rules that compelled the largest utilities in California to buy elec-

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[7] While respondent Snohomish suggests that Morgan Stanley withheld knowledge of market manipulation, Snohomish Br. 39-40, neither of the documents cited by Snohomish, *id.* at 40 n.25, suggests that Morgan Stanley had special knowledge of market manipulation. First, Morgan Stanley's trading manager made a comment about "artificial goosing up of reported trading volume" in a *published article* written in 1998—well *before* the 2000-2001 crisis in California spot markets—and containing only general comments on nationwide increases in trade volume. *See* Record No. 780, 10/9/02 Tr. 1971; Record No. 781, 10/10/02 Tr. 1989; Record No. 1628, Ex. SNO-86 at 5-6. (Indeed, as Morgan Stanley successfully objected, the article had "nothing to do with the practices of Morgan Stanley Capital Group," 10/9/02 Tr. 1973-74, and was never admitted into evidence. *See* 10/10/02 Tr. 1992-93.) Second, in a conversation with Morgan Stanley's negotiator, an official from the Northern California Power Agency noted a "spread" in spot-market prices at different locations and suggested several possible explanations, including artificial transmission congestion. Record No. 1648 at 55-66. The transcript shows that neither individual had any knowledge of market manipulation, but both found the price spread puzzling in light of the actions of regulators and publicly available information. *See id.* at 60 ("[I]t doesn't make much sense, does it?").

tricity in spot market rather than in forward market transactions. *See* Pet. App. 249a-269a; Snohomish Br. 14. FERC accordingly prescribed the opening of forward markets as an "essential remedy" to the spot markets crisis. *San Diego Gas*, 93 F.E.R.C. at 61,539. Forward contracts enabled purchasers of power to attain long-term stability in place of the price volatility that plagued the spot markets. Respondent Snohomish explained to its customers that its long-term supply contracts "give us a lot of security against the uncertainty of market fluctuations." Pet. App. 166a. Yet if those long-term contracts were deemed unenforceable by the seller on the basis of a post hoc determination that there had been manipulation in an adjacent spot market, the effect perversely would be to discourage sellers from offering forward contracts, to drive up forward prices still more, and to induce buyers to rely to an even greater extent on the spot markets—and thereby to exacerbate the conditions that gave rise to the problem in the first place.

Respondents, like the Ninth Circuit, rely substantially on the notion that anticompetitive conduct in the spot market had the effect of elevating prices in the forward market. *See* Pet. App. 59a; CPUC Br. 49-50. But that would be no reason to deem the forward markets themselves "dysfunctional" or to invalidate the contracts at issue. When demand for power is high and supply in spot markets is scarce, one would expect the price of power in adjacent forward markets to rise as result of ordinary market dynamics, because prices in a forward market *necessarily* reflect expectations about future spot market prices. In this case, the contracting parties had access to the same information about market conditions, and all of the parties made predictive judgments about the future state of the markets when they agreed to the contract terms. Denying sellers the ability to enforce the terms of their forward sales solely because the buyers' judgment ultimately proved to be incorrect would discourage sellers from engaging in forward sales altogether, which would in turn only prolong or exacerbate any shortage in supply. What is more, petitioners in these cases act as both sellers and buyers in trading power as a commodity, *see* J.A. 1261a, such that any immediate benefit of elevated prices to them as a seller may be offset by a burden on them as a buyer. There is all the more reason in that context to apply the *Mobile-Sierra* framework and enforce the terms of forward supply agreements.

Finally, it bears emphasis that more targeted means are available to address manipulative and anticompetitive practices. Under respondents' apparent view, if forward contracts are negotiated at a time in which some manner of imperfection is later found to have existed somewhere in an adjacent spot market (or even if a known imperfection is found to have been more profound than had been understood contemporaneously), *any* forward contract negotiated in that period could be subject to modification at the option of a buyer who turns out to have made an improvident deal. That regime would encourage buyers who wish to avoid their contractual obligations to expend substantial litigation costs in search of some market imperfection that would justify abrogation of their agreements. The better course would be to rely on existing mechanisms for identifying and addressing manipulative conduct. Of particular significance, a buyer who believes that a seller has market power can challenge the seller's market-based rate authorization before executing a contract, thereby preserving the right to a subsequent refund in the event of a successful challenge. *See Mont. Consumer Counsel v. PPL Mont., LLC,* 121 F.E.R.C. ¶ 61,127 (2007); *La. Energy & Power Auth. v. FERC*, 141 F.3d 364, 370-71 (D.C. Cir. 1998). Similarly, if a buyer believes that some or all sellers have market power in a market or sub-market, whether from the individual possession of market power or because of structural problems, the buyer can file a Section 206 complaint seeking to undo or limit sellers' market-based rate authority in the relevant market.[8] A buyer of course could also protect itself by negotiating for a *Memphis* clause entitling it unilaterally to seek regulatory modification of the contract rate. *See* p. 11, *supra.* In addition, FERC now possesses authority to take direct action against market manipulation, including the imposition of civil penalties. *See* 16 U.S.C. §§ 824v, 825o-1. Those sorts of measures more efficiently address manipulative conduct than giving buyers a broad entitlement to abrogate their wholesale energy contracts.

D. The *Mobile-Sierra* Framework Is Not Contingent On FERC's Having An Initial Opportunity To Assure That A Contract Rate Falls Within A Zone Of Reasonableness

The Ninth Circuit held, and respondents here argue, that the *Mobile-Sierra* presumption of contract validity is inapplicable because FERC had no opportunity at the outset to judge whether the rates set in

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[8] *See*, *e.g.*, Complaint of Puget Sound Energy, Inc., F.E.R.C. Docket No. EL01-10-000 (filed Oct. 26, 2001).

these agreements are within a "zone of reasonableness." Snohomish Br. 41-45, 51; CPUC Br. 45-47; Pet. App. 46a-57a. That argument is materially flawed in a number of respects.

1. As an initial matter, respondents never explicitly identify the center of the "zone of reasonableness," *i.e.*, the baseline rate against which FERC ostensibly would compare the rate negotiated by the contracting parties. Respondents appear to assume that FERC would apply the traditional, cost-based criteria that govern *non*-contract rates, and would examine whether the rate negotiated by the parties in the marketplace comes within an undefined "zone" of the cost-based rate that FERC would impose in the absence of a contract. *See*, *e.g.*, Snohomish Br. 31 (referring to "cost-related rates at the core of 'just and reasonable'"). *See also* Pet. App. 64a (price within "zone of reasonableness" only if price "part of a general trend toward rates that do reflect cost").

The *Mobile-Sierra* framework, however, is not grounded on the assumption that rates negotiated in the market qualify as just and reasonable because they would approximate the rate that would be imposed by FERC in a non-contract setting. Rather, *Mobile* and *Sierra* are premised on an understanding that the rate negotiated by sophisticated parties in the marketplace is at least as likely to qualify as just and reasonable—and to advance the long term interests of consumers—as the rate that would be imposed by a regulating body applying cost-based principles. As the Court has explained, "[i]n wholesale markets, the party charging the rate and the party charged were often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them." *Verizon Commc'ns Inc. v. FCC*, 535 U.S. 467, 479 (2002).

In *Mobile* and *Sierra*, accordingly, the Court applied a presumption of validity to the contract rate without regard to whether the Commission had initially reviewed the rate or compared it to the rate that the Commission would have imposed by applying traditional cost-based principles. In both cases, the Commission had accepted the contract rates for filing but made clear that its acceptance did not constitute approval of the rate. *See* MSCG Br. 41 & n.23. Respondents assert that the Commission in those cases "had the *opportunity* to review the contracts." Snohomish Br. 42 n.27; *see* CPUC Br. 25. That is entirely beside the point, because in neither case was the contract's validity in any way predicated on any initial review or approval by the Commission.

2. Even if some sort of initial review of the contract rates were required, such review was provided under FERC's market-based rate regime. In fulfilling its responsibilities under the FPA to "produce an abundance of electricity at the lowest possible cost,"[9] FERC has elected to implement a "market-based rate" approach to ensure "just and reasonable" rates. Under this system, FERC authorizes a wholesale seller of electricity to sell at negotiated rates—regardless of costs and profit—if FERC has first determined that the seller lacks the ability to "significantly influence price in the market by withholding service and excluding competi-

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[9] S. Rep. No. 74-621 at 17 (Senate Report to The Public Utility Act of 1935).

tors for a significant period of time." *Citizens Power & Light Co.*, 48 F.E.R.C. ¶ 61,210, 61,777 (1989). FERC imposes numerous reporting requirements on authorized sellers. A seller's application for market-based rate authority is open to public review and comment, FERC's subsequent grant or denial of market-based authorization is subject to judicial review, and once granted the seller's market-based rate authority can always be challenged under FPA Section 206. *See*, *e.g.*, *Mont. Consumer Counsel*, 121 F.E.R.C. ¶ 61,127.[10]

Respondents do not directly challenge FERC's authority to implement a market-based rate approach to rate review. *See* Snohomish Br. 42; CPUC Br. 43. And in any event, as FERC explains, its market-based rate regime is consistent with the FPA. FERC Br. 27-30.

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[10] In *FPC v. Texaco Inc.*, 417 U.S. 380, 382 (1974), the Court cautioned that "the prevailing price in the marketplace cannot be the final measure of 'just and reasonable' rates mandated by the Act." *Id.* at 397. In *FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 516-17 (1979), however, in responding to FERC orders that viewed *Texaco* as preventing FERC from relying on market forces to set rates, the Court explained that "*Texaco* did not purport to circumscribe so severely [FERC's] discretion to decide what formulas and methods it will employ to ensure just and reasonable rates. Indeed, the decision underscored the wide discretion vested in [FERC]." As the D.C. Circuit has explained, "nothing in *FPC v. Texaco, Inc.* precludes the FERC from relying upon market-based pricing." *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993). The court of appeals explained that the "Supreme Court's point in that case was only that . . . the market cannot be the 'final' arbiter of the reasonableness of a price." *Id.* (quoting *Texaco*, 417 U.S. at 397). The court affirmed FERC's determination that the rates at issue were just and reasonable based on the Commission's determination that the relevant gas pipeline's "markets are sufficiently competitive to preclude it from exercising significant market power." *Id.* at 870-71.

See, *e.g.*, *California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1011-13 (9th Cir. 2004). *cert. denied sub nom. Coral Power L.L.C. v. California ex rel. Brown*, 127 S. Ct. 2972 (2007); *Elizabethtown Gas*, 10 F.3d at 870.

If respondents' view were to prevail, serious questions would be raised about the viability of a market-based rate regime that looks to the market as the appropriate measure of prices that will most efficiently reconcile supply and demand over the long term. Under respondents' view, FERC must always assure at the outset that any market rate approximates a cost-related rate. Snohomish Br. 31, 36; CPUC Br. 45. But that requirement, as explained, is fundamentally inconsistent with the notion inherent in any market-based rate system that the appropriate rate is the one that sophisticated parties lacking market power arrive at after arm's-length bargaining.

Moreover, a market-based rate system, for good reasons, would not assume that prices would at all times reflect a traditional calculation of costs plus a reasonable return. For instance, prices rise when there is a shortage of supply in the market, yielding a premium for sellers and creating the necessary incentive to stimulate increased supply. That profit opportunity serves as signal for new entities to enter the market and for current participants to expand supply. It is a virtue of a market-based system that it encourages additional supply precisely when it is needed most.

Finally, for a market-based rate system to provide much of the benefit that it promises, it must permit some transactions on short notice, sometimes nearly instantaneously. That flexibility would be compromised if FERC were required to review and approve in advance every contract rate. *See* Pet. App. 266a (examining every long-term agreement "as if the seller was seeking new market-based rate authority" would be "a pointless exercise of no value to anyone"). A market-based rate system, in short, cannot in the long run function effectively under the limitations that the Ninth Circuit and respondents would impose upon it.

II. FERC CORRECTLY CONCLUDED THAT THERE IS NO UNEQUIVOCAL PUBLIC NECESSITY TO SET ASIDE THESE WHOLESALE ENERGY CONTRACTS

The *Mobile-Sierra* framework rests on the understanding that the FPA aims to "preserv[e] the integrity of contracts," such that FERC can modify contracts only "when necessary in the public interest." *Mobile*, 350 U.S. at 344. As the Court subsequently explained: "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; *see Ark. La. Gas Co. v. Hall*, 453 U.S. 571, 582 (1981) (FERC lacks authority "to 'abrogate existing contractual arrangements'" "absent extraordinary circumstances") (quoting *Permian Basin*, 390 U.S. at 820).

Whether modification of contracts in a particular case is in fact necessary "in the public interest is of course a question to be determined in the first instance by the Commission." *Sierra*, 350 U.S. at 355. Here, FERC correctly concluded that there is no unequivocal public necessity to modify the wholesale supply contracts in issue. *See* J.A. 1276a-1284a. FERC found "no credible record evidence that the contracts at issue are placing [respondents] in financial distress so as to threaten their ability to continue service or that other customers will bear an excessive burden as a result of upholding the challenged contracts." J.A. 1276a; *see Sierra*, 350 U.S. at 355. FERC made a number of factual findings in support of those conclusions, *see* J.A. 1277a-1284a, 1577a-1593a, and those findings are supported by substantial evidence, *see* 16 U.S.C. § 825*l*(b). FERC also explained that, unlike the sorts of "extreme circumstances" that have justified contract modification in the past, modification here would "if anything" be "contrary to the Commission's policy of respecting contract sanctity and creating the regulatory certainty needed to attract sufficient capital to competitive power markets." J.A. 1521a-1522a.[11]

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[11] For examples of the sorts of rare situations in which FERC has concluded that there is an unequivocal public necessity to modify contracts, *see Permian Basin*, 390 U.S. at 784 (upholding Commission's abrogation of thousands of contracts in order to establish an area-wide geographic system of setting natural gas rates); *FPC v. La. Power & Light Co*., 406 U.S. 621, 646 (1972) (upholding Commission's alteration of contracts in response to nationwide shortage of natural gas); *Arizona Corp. Comm'n v. FERC*, 397 F.3d 952, 953-55 (D.C. Cir. 2005) (upholding orders modifying the terms of settlements by, *inter alia*, converting gas shippers' contracts from full requirements to more costly contract demand service); *Ne. Utils. Serv. Co. v. FERC*, 55 F.3d 686, 692 (1st Cir. 1995) (upholding order that modified cost-based affiliate power sales contract provisions to protect third parties, including existing and future wholesale customers of the buyer); *Transmission Access*, 225 F.3d at 709 (upholding order "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").

Respondents devote the bulk of their attention to arguing that the *Mobile-Sierra* public interest standard is inapplicable in the circumstances of this case, and very little attention to arguing that they could satisfy that standard if it were to apply. Insofar as they address the latter issue, respondents simply assert that, even if the *Mobile-Sierra* framework permits contract abrogation only in "extraordinary circumstances," *see Arkansas Louisiana Gas*, 453 U.S. at 582, the 2000-2001 crisis in California spot markets amounted to "the most extraordinary circumstances in the history of the industry." Snohomish Br. 55. But while the crisis in California spot markets qualifies as "extraordinary" in an abstract sense, for all the reasons explained, it does not justify abrogation of the forward contracts which were an integral part of the solution to that crisis. Rather, FERC correctly concluded that the public interest is best served by enforcing the terms of these forward contracts. Accordingly, FERC's decisions should be sustained.

CONCLUSION

For the foregoing reasons, and for the reasons set out in the opening briefs for petitioners, the Ninth Circuit's decision should be reversed and the petition for review denied.

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