No. 06-1462

IN THE

Supreme Court of the United States

CALPINE ENERGY SERVICES, L.P.,
AMERICAN ELECTRIC POWER SERVICE CORP., AND
ALLEGHENY ENERGY SUPPLY COMPANY, 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

BRIEF FOR PETITIONERS

ROBERT F. SHAPIRO
MERRILL L. KRAMER
CHADBOURNE & PARKE LLP
1200 New Hampshire
Avenue, N.W.
Washington, D.C. 20036
(202) 974-5600
Counsel for Petitioner Allegheny Energy Supply Company, LLC

DONALD B. AYER
(COUNSEL OF RECORD)
CLARK EVANS DOWNS
LAWRENCE D. ROSENBERG
KENNETH B. DRIVER
SHAY DVORETZKY
JULIET J. KARASTELEV
JONES DAY
51 Louisiana Avenue, N.W.
Washington, D.C. 20001
(202) 879-3939
Counsel for Petitioner American Electric Power Service Corp.

November 21, 2007

[Additional counsel listed on inside front cover]

KEITH R. MCCREA
KENT L. JONES
WILLIAM H. PENNIMAN
SUTHERLAND ASBILL &
BRENNAN LLP
1275 Pennsylvania
Avenue, N.W.
Washington, D.C. 20004
(202) 383-0100
Counsel for Petitioner Calpine Energy Services, L.P.

MICHAEL J. GERGEN
JARED W. JOHNSON
LATHAM & WATKINS LLP
555 Eleventh Street, N.W.
Washington, D.C. 20004
(202) 637-2200
Counsel for Respondent (in support of Petitioners) Mirant Energy Trading, LLC

QUESTIONS PRESENTED

1. Whether the Ninth Circuit erred in holding that the *Mobile-Sierra* doctrine—which affirms the validity of long-term wholesale energy contract rates unless they are shown to be contrary to the public interest—is inapplicable to contracts negotiated in full compliance with FERC's market-based ratemaking regime, unless and until FERC retrospectively concludes that such contracts were negotiated under conditions free from any influence of "market dysfunction."

2. Whether the Ninth Circuit failed to honor *Mobile-Sierra*'s presumption of contract validity when it modified the public interest standard so that wholesale energy contract rates challenged by buyers as too high are modified downward whenever they are outside a zone of reasonableness defined at a later date.

PARTIES TO THE PROCEEDINGS AND CORPORATE DISCLOSURE STATEMENT

Petitioners American Electric Power Service Corporation; Allegheny Energy Supply Company, LLC; and Calpine Energy Services, L.P. intervened in the court of appeals. Other intervenors included BP Energy Company, L.P.; El Paso Merchant Energy, L.P.; Mirant Americas Energy Marketing (now Mirant Energy Trading LLC); Enron Power Marketing; Reliant Energy Services, Inc.; Nevada Public Utility Commission; and Morgan Stanley Capital Group, Inc.

Respondents Nevada Power Company; Sierra Pacific Power Company; Public Utility District No. 1 of Snohomish County, Washington; Golden State Water Company (formerly Southern California Water Company); and Office of the Nevada Attorney General, Bureau of Consumer Protection were petitioners in the court of appeals.

Respondents Public Utilities Commission of the State of California and California Energy Oversight Board were intervenors in the court of appeals.

The Federal Energy Regulatory Commission was the respondent in the court of appeals.

Pursuant to Supreme Court Rule 29.6, Petitioner American Electric Power Service Corporation states that it is a subsidiary of American Electric Power Company, Inc. ("AEP Inc."), a New York corporation whose common stock is held by the public. AEP Inc. has no parent company, and no publicly held company has a 10 percent or greater ownership interest in AEP Inc.

Petitioner Allegheny Energy Supply Company, LLC is a Delaware limited liability company that is a direct subsidiary of Allegheny Energy, Inc. There are no companies that own a 10 percent or greater interest in Allegheny Energy, Inc., a Maryland corporation whose common stock is held by the public.

Petitioner Calpine Energy Services, L.P. ("CES") is a Delaware limited partnership. CES is an indirect, wholly owned subsidiary of Calpine Corporation, a Delaware corporation whose common stock is traded on the Pink Sheets. No publicly held company owns more than 10 percent of Calpine Corporation's stock.

Mirant Energy Trading, LLC (formerly Mirant Americas Energy Marketing LP) ("Mirant") filed a timely response supporting the Petition pursuant to Supreme Court Rule 12.6 and is therefore a Respondent in support of Petitioners entitled to file documents with this Court. For ease of reference, the Brief refers to "Petitioners" as including Mirant. Mirant is owned by Mirant Corporation. No publicly held company owns more than 10 percent of the stock of Mirant Corporation.

TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

TABLE OF CONTENTS
(continued)

TABLE OF AUTHORITIES

Page

CASES

TABLE OF AUTHORITIES
(continued)

Page

TABLE OF AUTHORITIES
(continued)

Page

TABLE OF AUTHORITIES
(continued)

Page

TABLE OF AUTHORITIES
(continued)

Page

STATUTES AND LEGISLATION

RULES AND REGULATIONS

ARTICLES AND REPORTS

TABLE OF AUTHORITIES
(continued)

Page

INTRODUCTION

For 51 years, this Court's *Mobile-Sierra* doctrine has provided a presumption of validity for arm's-length, wholesale energy contracts, and thus assured good-faith buyers and sellers that rates set by contract would be enforced absent a showing of a contrary public interest. By imposing prerequisites to the application of this presumption, and by lowering the public interest showing required to overcome it where long-term rates are challenged as too high, the Ninth Circuit has ignored the Federal Power Act's respect for private contracts and destroyed the doctrine's effectiveness as a source of certainty on which market participants can rely. Accordingly, this Court should reverse the decision below and reaffirm the continuing force of the *Mobile-Sierra* doctrine.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 471 F.3d 1053 (9th Cir. 2006) and is reprinted in the Appendix to the Petition (Pet. App.) at 1a. The related decision is reported at 474 F.3d 587 (9th Cir. 2006). Pet. App. 364a. The decision of the Administrative Law Judge is reported at 101 FERC ¶ 63,031 (2002). Pet. App. 68a. The orders of the Federal Energy Regulatory Commission ("FERC" or "the Commission") are reported at 103 FERC ¶ 61,353 (2003), Pet. App. 246a, and 105 FERC ¶ 61,185 (2003), Pet. App. 314a.

JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on December 19, 2006. No party sought en banc rehearing. On March 8, 2007, Justice Kennedy signed an order extending the time for filing a petition for certiorari until May 3, 2007. The petition for writ of certiorari was filed on May 3, 2007 and granted on September 25, 2007. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

The relevant provisions of the Federal Power Act, 16 U.S.C. §§ 791a-828c, are reproduced in the Appendix to the Petition, Pet. App. 381a-395a.

STATEMENT

A. Statutory and Regulatory Context

1. The Federal Power Act

The Federal Power Act ("FPA") was enacted in 1935 to limit the control by a few public utility holding companies of the Nation's electric utility systems and ensure a stable supply of affordable electrical power. Public Utility Act of 1935, ch. 687, 49 Stat. 803. Section 201(a) of the FPA declares that "the business of transmitting and selling electric energy for ultimate distribution to the public is affected with a public interest," and federal regulation of "the transmission of electric energy in interstate commerce and the sale of such energy at wholesale in interstate commerce is necessary in the public interest." 16 U.S.C. § 824(a).

Among other things, the FPA authorized the Federal Power Commission ("FPC") and its successor, FERC, to review contracts (including the rates and charges therein) for the sale for resale of electricity in interstate commerce. Section 205(a) provides that "[a]ll rates and charges" by public utilities "in connection with the transmission or sale of electric energy" shall be "just and reasonable," and that any such rate or charge "that is not just and reasonable" is "declared to be unlawful." 16 U.S.C. § 824d(a). Section 205(c) provides that, "[u]nder such rules and regulations as the Commission may prescribe," each public utility "shall file with the Commission, within such time and in such form as the Commission may designate . . . schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission," together with "all contracts" related to such transactions. 16 U.S.C. § 824d(c).

It has long been the common practice of FERC to "accept" a filed rate and, absent apparent reasons to investigate, permit it to become effective without making findings of its "justness and reasonableness," regardless of whether the rate is based on the utility's costs or market referents. *See Mont.-Dakota Utils. Co. v. Nw. Pub. Serv. Co.*, 341 U.S. 246, 255-56 (1951) (Frankfurter, J., dissenting) ("[T]he legality of rates . . . is not conditioned upon the Commission's approval. Unless they are challenged, either by an interested party or on the Commission's initiative, the filed rates become the legal rates."). FERC's acceptance of a rate schedule therefore "shall not constitute approval" of the rate. *See* 18 C.F.R. § 35.4 (2007).

Under Section 206, whenever FERC (acting on a complaint or *sua sponte*) determines that a rate or charge under its jurisdiction is "unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate" to be "thereafter observed and in force, and shall fix the same by order." 16 U.S.C. § 824e(a). The effective date of any such change can be no earlier than the date the complaint was filed. § 824e(b).

2. The *Mobile-Sierra* Doctrine

In *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956), and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956), this Court addressed the interaction of the FPA's requirement that all rates be "just and reasonable" with the statute's "premise[] [of] a continuing system of private contracting." *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968). In those decisions, the Court articulated the so-called *Mobile-Sierra* doctrine, which bars FERC from modifying or setting aside a negotiated, fixed-rate contract absent a showing that doing so is necessary to protect the public interest.

In *Mobile*, a natural gas company ("United") entered a ten-year, fixed-rate contract to sell gas to a distributor ("Mobile"). Seven years later, United attempted unilaterally to increase the rate charged to Mobile by filing a new tariff with the FPC. This Court unanimously held that "the contract rate remained the only lawful rate." *Mobile*, 350 U.S. at 347. The Court explained that the Natural Gas Act (the rate provisions of which are materially identical to the FPA's rate provisions) "expressly recognizes that rates to particular customers may be set by individual contracts," and "evinces no purpose to abrogate [such] private rate contracts." *Id.* at 338, 341. It further recognized that "preserving the integrity of contracts . . . permits the stability of supply arrangements" on which "substantial investments" necessary to ensure adequate supplies of energy depend. *Id.* at 344.

Thus, market participants may choose "to fix by contract, and change only by mutual agreement, the rate agreed upon with a particular customer." *Id.* at

343. Pursuant to Section 206, "all rates are subject to being modified by the Commission upon a finding that they are unlawful." *Id.* at 341. But the Commission's limited authority to modify privately negotiated rates is "neither a 'rate-making' nor a 'rate-changing' procedure," and may be invoked only when it is "necessary in the public interest." *Id.* at 341, 344.

In *Sierra*, a unanimous decision issued on the same day as *Mobile*, the Court elaborated on contract stability and other factors behind the statute's conception of the public interest. In that case, a distributor of electricity ("Sierra") obtained additional power from a public utility ("PG&E") in response to "increased postwar demands and consumer agitation for cheaper power." *Sierra*, 350 U.S. at 351-52. Sierra had alternative sources of supply, "including the Federal Bureau of Reclamation, which at the time had unused capacity at Shasta Dam." *Id.* at 352. Thus, "[t]o forestall the potential competition, PG&E offered Sierra a 15-year contract for power at a special low rate" that afforded PG&E a 2.6% rate of return, well below its normal 5.5% rate. *Id.* at 352-54. Later, "when power from Shasta Dam was no longer available to Sierra," PG&E filed a new schedule with the Commission, increasing Sierra's rate by 28 percent. *Id.* at 352. The FPC allowed PG&E to abrogate the original contract, concluding that it was "unreasonable" because its rate of return was "substantially less than the 4.75% resulting from the proposed rate, which is the minimum PG&E is willing to accept." *Id.* at 354.

This Court stated that "the purpose of the power given the Commission by § 206(a) is the protection of the public interest, as distinguished from the private interests of the utilities, [as] evidenced by the recital in § 201 of the Act that the scheme of regulation imposed 'is necessary in the public interest.'" *Id.* at 355. Thus, the Court held that the FPC had no authority under the FPA to undo the valid agreement between PG&E and Sierra. It explained that a public utility may "agree by contract to a rate affording less than a fair rate of return," and if it does so, it is not "entitled to be relieved of its improvident bargain." *Id.* "In such circumstances," this Court held, "the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Id.*

In *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division*, 358 U.S. 103 (1958), the Court confirmed that the principle underlying the *Mobile-Sierra* doctrine reflects the FPA's respect for rates determined through freely negotiated contracts. The Court also recognized that, if contracting parties expressly choose to reserve the right to apply to the Commission to modify a contract's terms, such right should be honored. In *Memphis*, the parties to a long-term gas contract included a provision that permitted the seller to raise rates unilaterally by filing a new schedule with the Commission, subject to the Commission's review for justness and reasonableness. *Id.* at 111. The Court upheld the seller's right to enforce the bargain that it had struck. "The important and indeed decisive difference between [*Memphis*] and *Mobile* is that in

Mobile one party to a contract was asserting . . . the right unilaterally to abrogate its contractual undertaking," whereas in *Memphis*, the seller sought "simply to assert . . . rights expressly reserved to it by contract." *Id.* at 112. Enforcing contractual rights is in the public interest, the Court explained, because it protects "the legitimate interests of [energy producers] in whose financial stability the [energy]-consuming public has a vital stake." *Id.* at 113. Indeed, without such a commitment to honor agreements, "the maintenance and expansion of [energy] systems through equity and debt financing would become most difficult, if not impossible." *Id.*

These holdings have governed FERC's regulation of interstate wholesale power markets for more than 50 years, and this Court and courts of appeals have consistently reaffirmed them. Recently, in *Verizon Communications Inc. v. FCC*, 535 U.S. 467 (2002), this Court reiterated that "[i]n wholesale markets, the party charging the rate and the party charged [are] often sophisticated businesses enjoying presumptively equal bargaining power," and for that reason can "be expected to negotiate a 'just and reasonable' rate as between the two of them." *Id.* at 479. Thus "[w]hen commercial parties d[o] avail themselves of rate agreements, [FERC's] principal regulatory responsibility [is] not to relieve a contracting party of an unreasonable [wholesale] rate" or to regulate rates ultimately paid by retail consumers, "but to protect against potential discrimination by favorable contract rates between allied businesses to the detriment of other wholesale consumers." *Id.*

3. Evolution of Competitive Power Markets and Market-Based Rate Regulation

Before 1978, the electric power industry was dominated by vertically integrated firms that generated electricity in their own power plants, transmitted such electricity on their own transmission systems, and distributed that electricity to their own retail customers in franchised monopoly service areas. *See* Jeffrey D. Watkiss & Douglas W. Smith, *The Energy Policy Act of 1992: A Watershed for Competition in the Wholesale Power Market*, 10 Yale J. on Reg. 447, 451-52 (1993). Transmission systems were generally not used to supply neighboring electric utilities.

In the 1970s, prices for electricity increased and became more volatile as high oil costs, high inflation, the disallowance by state regulators of major utility investments (such as nuclear investments), and new environmental legislation made power more expensive to produce. In response to these trends, Congress passed the Public Utility Regulatory Policies Act of 1978, Pub. L. No. 95-617, 92 Stat. 3117 (codified as amended at 16 U.S.C. §§ 2601-2645 and scattered sections) ("PURPA"). *See FERC v. Mississippi*, 456 U.S. 742, 750-51 (1982). PURPA authorized certain non-utility generators to sell their electricity output to franchised utilities at a price capped by the costs avoided by the utility by not generating the same electricity itself. *See* Watkiss & Smith, *supra*, at 452-53; *Am. Paper Inst. v. Am. Elec. Power Serv. Corp.*, 461 U.S. 402, 404-06 (1983). This had the effect of introducing competition from "independent power producers"—sellers not affiliated with vertically integrated utilities—into the business of electricity supply. Watkiss & Smith, *supra*, at 453.

Competition in electricity supply grew rapidly in the 1980s and 1990s. The Energy Policy Act of 1992 further encouraged entry by new competitors, relieving independent power producers of the burden of federal regulation under the Public Utility Holding Company Act of 1935 and expanding FERC's ability to require utility transmission systems to carry energy produced by other suppliers. Watkiss & Smith, *supra*, at 456-76. These same developments encouraged traditional utilities to meet their energy needs by purchasing energy from third-party suppliers rather than constructing new generation facilities.

In 1989, following an approach first pursued in the natural gas industry, FERC began authorizing electric power marketers to sell wholesale electric energy at market-based rates below a set cap (based on the cost avoided by the purchaser), pursuant to a single "blanket" sales tariff. *Citizens Power & Light Corp.*, 48 FERC ¶ 61,210, at 61,774-76 (1989). FERC concluded that marketers could re-combine existing products to create new ones, and their presence would "increase efficiency in power supply markets and in turn ultimately lower the cost of electricity." *Id.* at 61,776. As FERC later explained, market-based rates "helped to develop competitive bulk power markets," and allowed generating utilities to "move more quickly to take advantage of short-term or even long-term market opportunities."[1]

[1] Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and

In this way, market-based rates furthered FERC's goal "to facilitate the development of competitively priced generation supply options, and to ensure that wholesale purchasers of electric energy can reach alternative power suppliers and vice versa." [2] Indeed, consumers have enjoyed dramatic cost savings due to the competitive power markets facilitated by market-based rates. *See* Cambridge Energy Research Associates, *Beyond the Crossroads: The Future Direction of Power Industry Restructuring* 1 (2005) (concluding that consumers saved approximately $34 billion between 1997 and 2004 compared to the costs that would have been incurred under traditional regulation); Scott M. Harvey et al., *Analysis of the Impact of Coordinated Electricity Markets on Consumer Electricity Charges* 1 (2006), *available at* http://www.pjm.com/documents/downloads/reports/20061121-analysis-coordinated-elec-mkts.pdf) (finding that consumers save $1.2 million per day in certain areas due to markets made possible by the market-based rate regime).

In 1993, FERC eliminated the price cap on market-based rates. *Louisville Gas & Elec. Co.*, 62 FERC ¶ 61,016, at 61,143 n.15 (1993). FERC found

(continued…)

Transmitting Utilities, Order No. 888, 61 Fed. Reg. 21,540, 21,545 (May 10, 1996), *aff'd in relevant part after reh'g sub nom. Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom. New York v. FERC*, 535 U.S. 1 (2002) (hereinafter "Order No. 888").

[2] Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, 59 Fed. Reg. 35,274, 35,278 (proposed July 11, 1994).

that market-based rates were appropriate if "the seller can demonstrate that it lack[ed] market power over the buyer or [had] adequately mitigated its market power." *Id.* at 61,143. Market power "exists when a seller can significantly influence price in the market by withholding service and excluding competitors for a significant period of time." *Citizens*, 48 FERC ¶ 61,210, at 61,777.

To demonstrate lack of market power, FERC required a seller to show that "neither it nor any of its affiliates: (1) is a dominant firm in the sale of [electricity] in the relevant market; (2) owns or controls transmission facilities through which the buyer could reach alternative sellers (or, if the seller or any of its affiliates does own such facilities, it has adequately mitigated its ability to block the buyer from reaching other sellers); and (3) can erect or control any other barrier to market entry." *Louisville*, 62 FERC ¶ 61,016, at 61,144. The seller also was required to show that it could not discriminate in favor of affiliated companies. *Id.* Market-based rate authorization was, however, subject to triennial review and the seller's ongoing obligation to inform FERC regarding changes in the conditions that formed the basis for the authorization. *See Citizens*, 48 FERC ¶ 61,210, at 61,778. Such ongoing obligations provided FERC the opportunity to ensure that a seller continued to qualify for market-based rate authorization, and to revoke it if the seller violated the tariff's conditions. *See, e.g.*, *Enron Power Mktg.*, 103 FERC ¶ 61,343, at 62,302 (2003).

Any person who believes a seller has unmitigated market power can oppose the seller's initial application for market-based rate authority or file a complaint under Section 206 seeking revocation of the seller's existing market-based rate authority. Such a challenge filed prior to the execution of a market-based rate contract may provide grounds for later retroactive refunds under the contract. *Mont. Consumer Counsel v. PPL Mont., LLC*, 121 FERC ¶ 61,127 (2007).

In the mid-1990s, FERC reformed the wholesale electricity market and "unbundled" transmission service from the wholesale sale of electric energy. *See Transmission Access Policy Study Group*, 225 F.3d at 681-83. FERC determined that open, non-discriminatory access to transmission service is "critical to the full development of competitive wholesale generation markets and the lower consumer prices achievable through such competition." Order No. 888, 61 Fed. Reg. at 21,550 n.105. FERC thereby sought to ensure that "customers have the benefits of competitively priced generation." *Id.* By 2000, franchised utilities in many regions of the country rarely constructed new generating units to meet their customers' demand for electricity, but instead relied increasingly on purchases of electricity in the wholesale markets.

B. Statement of the Case

1. The Crisis in the California Spot Markets

California restructured its electric power industry in 1996. *See In re Cal. Power Exch. Corp.*, 245 F.3d 1110, 1114 (9th Cir. 2001) ("*CalPX*"). The State required its largest investor-owned utilities ("IOUs") to divest most of their generation assets and froze their retail rates. *See id.* at 1114-15. California created the California Independent System Operator ("CAISO"), which operated the

State's electric transmission grid and also operated a real-time "spot" market to keep market supply and demand in balance, *id.* at 1115, and the California Power Exchange Corporation ("CalPX"), which operated an auction-based spot market for trading electric energy. *Id.* at 1114. "Spot market sales" are sales that are 24 hours or less in duration and "are entered into the day of or day prior to delivery." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Serv.*, 95 FERC ¶ 61,418 ("*San Diego III*"), at 62,545 n.3 (2001). The IOUs also "were required to sell all of their remaining generation capacity into, and to purchase all of their required electricity supply from, the CalPX spot markets, and such purchases were deemed to be 'prudent per se' by" the California Public Utilities Commission ("CPUC"). *See CalPX*, 245 F.3d at 1114-15.

The State's decision to rely entirely on the spot markets proved to be an unmitigated disaster. In its early years, the restructured market produced lower electricity prices. However, as demand increased in the summer of 2000, wholesale electricity prices in California jumped dramatically, *see San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,121 ("*San Diego I*"), at 61,353-54 (2000), and prices in the "CalPX spot markets spiked particularly sharply." *CalPX*, 245 F.3d at 1115. In July 2000, FERC directed its staff to investigate the factors affecting prices in California and western markets. *San Diego I*, 93 FERC ¶ 61,121, at 61,354. On November 1, 2000, FERC issued an order summarizing its staff's findings that three factors contributed to high prices. *Id.* *First*, "competitive market forces played a major role . . . through significantly increased power production costs combined with increased demand due to unusually high temperatures and a scarcity of available generation resources" throughout the region. *Id.* *Second*, "existing market rules" and "flawed retail regulatory policies exacerbated the situation," *id.*, primarily due to "over reliance on spot markets." *Id.* at 61,359. *Third*, there was "evidence suggesting that sellers had the potential to exercise market power," but the data was "not sufficient to make determinations regarding the exercise of market power by individual sellers." *Id.* at 61,355.

On December 15, 2000, FERC took prospective action to rein in the spot markets by: (1) eliminating the requirement that the California IOUs sell all of their generation into, and buy all of their energy from, the CalPX spot markets; (2) establishing an interim $150/MW "breakpoint" in the CalPX spot market such that bids higher than $150 would no longer be considered in setting the "market clearing price"; (3) establishing a new CAISO "underscheduling" charge to discourage CAISO transmission customers from scheduling transmission service in a manner that enabled them to meet too much of their energy needs through the CAISO imbalance energy spot market; and (4) adopting a $74 per megawatt-hour ("MWh") advisory benchmark for "long-term contracts negotiated under current market conditions." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,294 ("*San Diego II*"), at 61,982-83, 61,994-95 (2000).

On June 19, 2001, FERC issued an order finding that California's reliance on the spot market had dropped sharply. *San Diego III,* 95 FERC ¶ 61,418, at 62,546. It also found that spot market prices had dropped dramatically, and that prices in the forward markets had decreased. *Id.*

FERC denied requests to extend price mitigation measures into the forward markets. *Id.* at 62,556. In a December 19, 2001 order on rehearing, FERC explained that mitigating spot market prices would protect customers in forward markets from potential non-competitive prices because buyers could reject forward contract offers and purchase energy in the mitigated spot markets. *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 97 FERC ¶ 61,275, at 62,245 (2001). A primary goal of FERC's remedial order was to "eliminate undue reliance on spot markets" and "to encourage longer-term contracting." *Id.* at 62,229.

In late 2001 and early 2002, after lower rates in the forward markets had persisted for several months, purchasers filed nineteen individual complaints with FERC claiming that the higher rates in their forward contracts, entered into between late 2000 and mid-2001, were unjust and unreasonable under Section 206 of the FPA because those rates had been adversely affected by the then-"dysfunctional" California spot markets. *See* David G. Tewksbury & Stephanie S. Lim, *Applying the* Mobile-Sierra *Doctrine to Market-Based Rate Contracts*, 26 Energy L.J. 437, 438 & 448-49 (2005) (identifying and briefly describing the nineteen complaints and three FERC proceedings established to address them). Among others, complaints were filed by Nevada Power Company and Sierra Pacific Power Company ("Nevada Companies") against Petitioners American Electric Power Service Corp. ("AEP"), Allegheny Energy Supply Company, LLC ("Allegheny"), Mirant Americas Energy Marketing

LP ("Mirant") and six other power marketers. Southern California Water Company ("SCWC"), now Golden State Water Company ("Golden State"), filed a similar complaint against Mirant.

2. The ALJ Decision

FERC set the complaints for hearing before an Administrative Law Judge "to determine whether the dysfunctional [California] spot markets adversely affected the long-term bilateral markets, and if so, whether the effect was of a magnitude warranting modification of [the parties'] contracts." Pet. App. 69a. In so doing, FERC opined that its "long-standing policy . . . has been to recognize the sanctity of contracts" and that this has "become even more critical" today because "[c]ompetitive power markets simply cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty, including certainty that the Commission will not modify market-based contracts unless there are extraordinary circumstances." JA 1099a (emphasis removed).

After extensive hearings, the ALJ, in a lengthy decision, Pet. App. 69a-245a, concluded that Complainants had "failed to establish that the dysfunctions of the [California] spot markets adversely affected the long-term bilateral markets," Pet. App. 69a, or that there were any "adverse effects warranting contract modification." Pet. App. 181a-182a.

The ALJ reviewed the contracts and concluded that each contract's language "excluded the possibility of [the parties] unilaterally seeking modifications," Pet. App. 84a, and thus that "*Mobile-Sierra* applies in order to preserve the contractual expectations of [the] parties by limiting modification" to those circumstances where "the public interest so requires." Pet. App. 85a. The ALJ rejected Complainants' arguments that *Mobile-Sierra* did not apply to short-term forward contracts or challenges to rates that were "too high," concluding that "*Mobile-Sierra* does not distinguish the length of the contracts, whether the rates are low or high or whether the complaint is filed by the buyer." Pet. App. 88a-89a.

The ALJ further found that the dysfunction in the California spot markets did not adversely affect the forward markets and that the changes in the spot and forward prices resulted largely from market fundamentals. Pet. App. 109a. The ALJ relied in part on prior Commission findings, see *supra* pp. 13-14, that high prices in the California spot markets were driven by competitive market forces and flawed market rules imposed by the State of California. Pet. App. 108a. She noted that the market forces at work were "increased power production costs combined with increased demand, due to unusually high temperatures and a scarcity of available generation resources." Pet. App. 102a. California's market rules exacerbated the effects of scarcity by preventing IOUs from negotiating forward contracts, and thus compelling excessive reliance on the volatile spot markets, Pet. App. 105a, which "was the central source of many of the dysfunctions in the California market." Pet. App. 117a.

The ALJ concluded that these design flaws in the California spot markets did not "adversely affect[] the Western long-term bilateral markets," and that "the prices in the forward markets, during the time the contracts at issue . . . were negotiated, were the direct result of competitive market forces at work in the marketplace." Pet. App. 139a-140a.[3] The ALJ explained that forward contract "prices are determined by expected *future* spot prices, which themselves are determined by expected future market fundamentals," Pet. App. 118a (emphasis added), which, in turn, may be influenced by many factors. Pet. App. 109a-111a. She recognized the possibility that high current spot prices, if expected to continue, can affect long-term contract prices, Pet. App. 118a, but concluded that such an elevation of forward contract prices is not an "adverse effect," but rather is "efficient" because it stimulates "investment in new capacity that is needed to serve customers adequately." Pet. App. 119a-120a. Accordingly, the ALJ concluded that the preponderance of the evidence showed that "the relationship between price determination in spot and forward markets . . . [was] attenuated." Pet. App. 135a.

Next, the ALJ considered the "totality of purchases and sales and the conditions present at the time the contracts were entered into," and concluded that they did not justify contract modification. Pet. App. 148a (internal quotation marks omitted). The ALJ concluded that the Nevada Companies deliberately undertook an aggressive procurement strategy, Pet. App. 150a-151a, by "purchasing solely short-term, fixed-price products," Pet. App. 154a, and that in doing so, the Nevada Companies were driven by their desire to "lock in power purchases early" before the market

---

[3] The ALJ noted that Complainants' witnesses "did not present any evidence of specific manipulation by [Petitioners] which impacted the forward markets generally or any contract at issue in this case specifically." Pet. App. 136a-137a.

learned of their then-existing financial distress. Pet. App. 152a. Most of these contracts covered future 90-day periods; two longer-term contracts to sell power to the Nevada Companies were filed with FERC before they became effective. *See* Pet. App. 79a. The ALJ found that the Nevada Companies "traded through five brokers and purchased forward power from more than thirty companies," Pet. App. 158a, at prices that, even the Nevada Companies admitted, "were at or below prevailing market rates." Pet. App. 160a-161a.

The ALJ found that Petitioners in this Court—power marketers who sold electricity to wholesale buyers—"did not set the price, but instead were subject to the prevailing market prices," Pet. App. 160a, and did not "exercise . . . market power" or "engage[] in discriminatory pricing." Pet. App. 137a-138a. She found further that the Nevada Companies' strategy was successful for a time. In 2000, the Nevada Companies realized a margin of $100 million by reselling power, which included sales in the California spot markets. Pet. App. 154a. Nevada Power's revenues from its resales of wholesale power increased 6.7 times from 2000 to 2001, and Sierra's revenues from such sales more than doubled in that period. *Id.*

The ALJ likewise held that the totality of circumstances surrounding the negotiation and execution of the SCWC-Mirant contracts did not support their modification. She found that SCWC was an active, sophisticated participant in the power markets, and it used a consulting firm to advise on its power purchases. Pet. App. 167a. The ALJ concluded that, despite SCWC's knowledge of increasing volatility and high prices in the spot markets, SCWC rejected a variety of supply options, including an offer in October 2000 from its then-supplier, Dynegy, for rates ranging from $46.50 to $54.50 per MWh depending on the length of the contract. Pet. App. 168a, 174a. Instead, SCWC purposely delayed issuing a request for proposals ("RFP") for a baseload contract until two months before its existing baseload contract expired. Pet. App. 168a. That course of conduct and the restrictive terms of the RFP led the ALJ to conclude that any "limitations" on SCWC's options "were the result of SCWC's calculated decisions." Pet. App. 175a.

The ALJ found that Mirant had to compete for the contract and offered initial and final prices that were "close to the price range" that SCWC desired. Pet. App. 169a-170a. Mirant's prices were also "substantially below the then-prevailing expected future spot market prices." Pet. App. 171a. The ALJ found that, in fact, SCWC "expected prices to drop," *id.*, but "chose to avoid price volatility by shifting the risks on to Mirant." Pet. App. 176a. SCWC thus obtained immediate "stability and price protection" from the contract, while "Mirant agreed to take an up-front loss. . . with the expectation that the losses would be made up in later years." Pet. App. 171a. Accordingly, the ALJ concluded that modifying the contract price would "provide a windfall to SCWC," which had received power from Mirant at a significant discount in the beginning months of the contract, and deny Mirant the "ability to earn a return on its risk in later years." Pet. App. 172a-173a.

The ALJ also found that none of the challenged contracts imposed an "excessive burden" on consumers or complainants. Pet. App. 210a, 214a. For example, the evidence demonstrated that the Nevada Companies were expecting to "file for a rate decrease in excess of 20 percent," due to their projections of "positive cash balances." Pet. App. 210a-211a. The ALJ found that the Nevada Companies also had adequate access to capital markets, Pet. App. 211a, and that there was no evidence that the Nevada Companies' "ability to serve their customers [was] threatened." Pet. App. 212a. The ALJ found that SCWC's contract price "seem[ed] reasonable" even though it exceeded FERC's advisory $74 per MWh benchmark, because the Mirant contract served SCWC's particular needs and because it was a 15-MW "odd lot" sale that could carry a slight price premium, rather than a more typical 25-MW block. Pet. App. 215a. The ALJ noted that SCWC reached a retail rate settlement at the CPUC that allowed it to "pass through to its customers most of the costs of [the] contract" with Mirant. Pet. App. 214a. The settlement provided that there be no rate increase for ratepayers who were permanent residents in SCWC's service territory, while those who owned second homes in that ski area would face an average total monthly electric bill of only $35.13. *Id.* Nothing in the record indicated that "SCWC's ability to continue doing business" was "in any way[] threatened," or that "the contract had a negative impact on its financial health." *Id.*

In rejecting the argument that modification of any of the challenged contracts would advance the public interest, the ALJ found that the evidence "demonstrates that contract modification would destroy investor confidence and threaten the viability of bilateral forward markets." Pet. App. 176a. The uncontradicted testimony was that "[e]nergy merchants rely on forward contracts . . . to provide 'stable and predictable cash flows'" in a volatile industry. *Id.* Modification of the contracts at issue would turn this "formerly stable cash flow into an undependable, risky cash flow." Pet. App. 177a. "This, in turn, could have an adverse effect on infrastructure development, especially at a time when Western markets need new generation and transmission." Pet. App. 179a. Moreover, "contract modification . . . . would increase the price thresholds at which [power] generators would choose to invest," which would in turn be passed on to consumers in the form of higher prices. *Id.*

3. FERC Decisions

FERC held oral argument and reviewed an extensive evidentiary record, including the record developed below, its staff's Final Report on Price Manipulation in Western Markets, and evidence submitted in the 100-Day Discovery Proceeding regarding market manipulation and gaming in the California spot markets. Pet. App. 248a, 257a.[4]

---

[4] On February 13, 2002, FERC initiated a staff investigation into whether Enron Corporation or any other entity "manipulated short-term prices in electric energy or natural gas markets in the West[.]" In May 2002, during a preliminary phase of the investigation, FERC released documents suggesting that Enron attempted to manipulate California electricity markets. In response to a court order addressing a related proceeding, FERC instituted proceedings to conduct "100 days" of discovery into "manipulation by various sellers" during the spot market crisis of 2000 and 2001. The "100-Day" discovery process concluded on March 20, 2003. On March 26, 2003, FERC staff issued its "Final Report on Price Manipulation in Western Markets," which concluded that: (1)

FERC "affirm[ed] . . . that the applicable standard of review" was "the 'public interest' standard." Pet. App. 248a-249a. Based on its review of the evidence and the totality of the circumstances, FERC found, with one dissent,[5] that "the challenged contracts are not contrary to the public interest." Pet. App. 251a-252a. FERC reaffirmed that "[t]he fact that a contract becomes uneconomic over time" as here—where Complainants initially "benefitted" from their contracts, but then "became dissatisfied with their bargains" following a drop in prices in mid-2001—"does not render [the contract] contrary to the public interest." Pet. App. 252a. In reaching this conclusion FERC made a number of findings discussed below. *See also* Pet. App. 246a-313a.

(continued…)

some market participants had manipulated the California spot price for natural gas, thereby affecting California electricity spot prices; (2) there was evidence that market participants affected California electricity spot market prices through manipulation, gaming, withholding, and bid inflation; and (3) there was a statistically significant correlation between spot and forward prices in the West from January 1, 2000 through June 30, 2001.

[5] Commissioner Massey dissented from FERC's order. In particular, he rejected the Commission's position that the justness and reasonableness of a rate is presumed once FERC grants market-based ratemaking authority to a seller, because he argued that this depends on there being a functioning competitive market, which was not, in his view, the case here because of the relationship between the spot and forward markets. Moreover, he urged that upholding these contracts violated the public interest because "[t]he tainted atmosphere in which these contracts were negotiated was unprecedented and extraordinary." JA 1317a.

FERC agreed with the ALJ that the language of the contracts reflected an intent to foreclose unilaterally initiated contract changes, and thus triggered *Mobile-Sierra*'s public interest test. Pet. App. 263a-265a. It also rejected Complainants' contention that the public interest test was inapplicable because the "market-based rate contracts at issue here . . . ha[d] not been previously reviewed and accepted for filing by the Commission." Pet. App. 265a. "The need for prior Commission review in these circumstances was met when, after determining that the [Petitioners] lacked market power or had taken steps to mitigate it, the Commission authorized all of the [Petitioners] to make sales of power at market-based rates." *Id.*

Applying the public interest test, FERC concluded that Complainants "had failed to make [the required] showing" that "the rates, terms, and conditions are contrary to the public interest." Pet. App. 293a. FERC first found that Complainants "failed to demonstrate that [the *Sierra* test] ha[d] been met or that any other factor introduced into evidence warrants a finding that any of the contracts is contrary to the public interest and should be modified." *Id.* FERC adopted the ALJ's findings that the contracts had not placed Complainants "in financial distress so as to threaten their ability to continue service." Pet. App. 293a-295a.

FERC then considered the ALJ's "extensive evidentiary record on the totality of the circumstances," and relied on her findings relating to Complainants' purchasing strategies, their deliberate decisions to undertake certain risks while being relieved of others, and the availability of other offers and/or sellers had they wished to consider them. Pet. App. 296a-300a. It concluded that "the challenged transactions were the result of Complainants' voluntary choices," Pet. App. 301a, including the choice to leave "themselves open to unnecessary risks." Pet. App. 300a. FERC found that "there is nothing in the record before the ALJ, in the Staff Final Report, or in the 100-Day Discovery Proceeding evidence to support a finding [of] market manipulation specific to the long-term contracts at issue[.]" Pet. App. 301a. Because there was also "no evidence of unfairness, bad faith, or duress in the original negotiations," FERC concluded that Complainants were "not entitled to change their bargains." *Id.*[6]

Upon Complainants' requests for rehearing and clarification, FERC reaffirmed its findings and conclusions. FERC reiterated that the appropriate standard of review was *Mobile-Sierra*'s public interest test, that there was overwhelming evidence that the contracts at issue did not harm the public

---

[6] The Commission also determined that, even assuming "that spot market distortions flowed through to forward power prices," and "that California [spot] markets were subject to market manipulation and gaming," these facts "would not be determinative of the issues in the instant proceeding." Pet. App. 292a. This is because the contracts at issue "evidence an intent that the contracts may be changed only pursuant to the 'public interest' standard of review." Pet. App. 293a. Even if it were true that manipulation in the spot market had some impact on the prices of forward contracts, "[e]vidence of [such] manipulation merely suggests yet another cause of the spot market dysfunctions," Pet. App. 292a, and "there is nothing in the record . . . to support a finding that there was market manipulation specific to the long-term contracts at issue here." Pet. App. 301a.

interest, and thus there was no basis for modifying those contracts. Pet. App. 315a-361a.

4. The Ninth Circuit Decision

The Ninth Circuit granted Complainants' petition for review and held that FERC "erred both in its procedural reliance on *Mobile-Sierra* and in the substantive standard it used in determining that the contracts at issue did not affect the public interest." Pet. App. 3a.

The Ninth Circuit first acknowledged that "private long term contracts can be generally governed by *Mobile-Sierra* . . . unless there is a specific indication in the contract that . . . rights [to unilaterally make or apply for changes] have been reserved," Pet. App. 43a (emphasis removed), and agreed with FERC that the contracts in this case "[did] not preclude *Mobile-Sierra* review." *Id.*

The Ninth Circuit next ruled that "although market-based rate authority *can* qualify as sufficient prior review to justify limited *Mobile-Sierra* review, it can only do so when accompanied by effective oversight permitting timely reconsideration of market-based rate authorization if market conditions change." Pet. App. 46a. The Ninth Circuit rejected FERC's determination that "because it requires, before granting market-based rate authority, a showing of lack of market power and regular reporting, it has therefore fulfilled its oversight role, and no further oversight is necessary." Pet. App. 51a. The court said that FERC cannot rely on its initial approval of a seller's market-based rate authority if FERC did not use an "effective oversight mechanism *after* the . . . authorization is initially granted," to ensure that the "basis for [the seller's] market-based rate authority" had not "atrophied." Pet. App. 48a, 53a. It found FERC's ongoing market monitoring mechanisms deficient because they did not permit an "inquiry into the actual state of the market at the time contracts were negotiated." Pet. App. 50a, 52a.

The Ninth Circuit thus held that "*Mobile-Sierra* cannot apply without a determination that the challenged contract was initially formed free from the influence of improper factors, such as market manipulation, the leverage of market power, or an otherwise dysfunctional market," Pet. App. 57a; that is, FERC must first "determine if the contracts at issue were initially entered into in fully functioning markets." Pet. App. 60a. The court found that FERC had committed a fundamental error in failing to consider with the benefit of hindsight "whether the influence of the spot markets on the forward markets reached a level sufficient to question whether . . . [the] parties had negotiated a 'just and reasonable' contract in the first instance." Pet. App. 58a, 60a.

Finally, the Ninth Circuit ruled that "FERC's error in its approach to deciding *whether* to apply the *Mobile-Sierra* presumption was compounded by its use of an erroneous standard for determining whether the challenged contracts affect the public interest." Pet. App. 60a. The court determined that when a buyer complains that a contract rate is too high, the public interest concerns "are not entirely parallel to those in a low rate case." Pet. App. 62a. It held that a "high-rate public interest determination should focus on whether consumers' electricity bills have been affected by the challenged rates," *i.e.*, "whether those bills are higher than they would otherwise have been had the challenged contracts called for rates within the just and reasonable range." Pet. App. 64a. According to the Ninth Circuit, the public interest requires modification of a "wholesale energy contract [whenever its rate] is outside the 'zone of reasonableness' and results in retail rates higher than would be the case if that zone were not exceeded." Pet. App. 64a-65a.

SUMMARY OF ARGUMENT

In *Mobile* and *Sierra*, decided on the same day in 1956, this Court addressed the interaction of nearly identical provisions of the Natural Gas Act and the Federal Power Act, which, on the one hand, clearly contemplated that wholesale energy rates would commonly be set by voluntary, bilateral contracts, and, on the other hand, required that all rates be "just and reasonable."

The resulting *Mobile-Sierra* doctrine, announced by a unanimous Court, held that the rates set in freely negotiated wholesale energy contracts are presumptively just and reasonable, and may be set aside only where they are demonstrably contrary to the public interest. The Court concluded that the statute's limited authority to modify privately negotiated rates is "neither a 'rate-making' nor a 'rate-changing' procedure." *Mobile*, 350 U.S. at 341.

Both cases thus refused to allow sellers of energy under long-term contracts to unilaterally secure the modification of the rates set by contract simply because prevailing rates had changed since the time of execution and rendered the contract price no longer just and reasonable.

In so holding, the Court recognized that adequate supplies of energy depend on the willingness of private entities to make substantial investments to meet future needs, which in turn depend on "preserving the integrity of contracts" in order to "permit[] the stability of supply arrangements." *Mobile*, 350 U.S. at 344. The *Mobile-Sierra* doctrine has, for the past half-century, provided a high level of certainty that arm's-length contracts between sophisticated participants in the electricity supply markets will be honored, absent the most exceptional circumstances.

During the intervening years, FERC has moved to a scheme of market-based regulation of wholesale electric power sales. Since the 1980s, FERC has issued blanket authorizations to individual sellers of power to enter into wholesale transactions at negotiated rates. These authorizations come only after a detailed initial review and determination that neither the seller nor its affiliates possess market power in the relevant market, or control critical transmission resources that would give the seller or its affiliates a significant advantage over the rest of the market.

These grants of market-based ratemaking authority, which are subject to subsequent review by FERC and may be revoked prospectively, allow the authorized sellers to file a single tariff indicating that sales will be made at market-based rates, and thereafter to enter into contracts at negotiated prices without seeking prior approval or filing separately with FERC. This flexibility affords such sellers the opportunity to respond quickly to market conditions, and to agree on short notice to sales in quantities, for durations, and at prices that the market demands.

This case presents the question of how this Court's *Mobile-Sierra* doctrine applies to FERC's scheme of market-based ratemaking. The increased reliance on market-based rates means that individually negotiated contracts play an even more crucial role in the process of supplying wholesale electric power, and thus make the reliability of expectations under those contracts even more critical to the "stability of supply." There is no reason to question the doctrine's continuing application to challenges to market-based contract rates brought by contracting parties where the passage of time has shown their contractual bets to be less than optimal.

The decision below has redefined this Court's *Mobile-Sierra* doctrine in a manner that renders it all but irrelevant in the context in which its continued respect is most important—in the face of an energy shortage, where buyers seek stability of supply at somewhat reduced prices, and sellers seek long-term commitments at a price that will justify the investments necessary to meet demand.

The Ninth Circuit was presented with the facts surrounding the California energy crisis of 2000-2001, in which a perfect storm of hot weather, scarcity of generation supply, flawed market rules in California, and instances of manipulative conduct in the California spot markets temporarily resulted in extraordinarily high spot market prices. In this context, the Ninth Circuit rewrote *Mobile-Sierra*, ostensibly to deal with the possibility that "dysfunctions" in the California spot markets could have influenced prices in the forward markets, and rendered them unjust and unreasonable. Its modifications conflict with the core purpose of the doctrine, destroying the reliability of energy contracts to the detriment of consumers.

The Ninth Circuit erred in holding that the *Mobile-Sierra* presumption of contract validity applies to market-based rate contracts only if FERC undertakes an after-the-fact, retrospective review of market conditions under which the contract was formed and determines that the relevant market was workably competitive and that prices were not influenced by any market "dysfunction," either in that market or in any market likely to have any influence on its prices. The *Mobile-Sierra* presumption arises from the parties' voluntary agreement, not from FERC's initial review of the rate or market conditions at the time of contract formation. And the notion that a hindsight finding of market dysfunction would render the *Mobile-Sierra* presumption wholly inapplicable, even though the contract at issue was freely formed, is anathema to the doctrine and disastrous for the public interest.

The Ninth Circuit next erred in holding that, assuming *Mobile-Sierra* applied, the nature and effect of the *Mobile-Sierra* public interest standard is entirely different in so-called "high-rate" and "low-rate" cases. The court acknowledged that in a low-rate case a challenged contract can be modified only in very rare cases, such as where "an excessive burden" on consumers is shown. The Ninth Circuit held that in a high-rate case contracts must be modified whenever the contract rate is outside of an ill-defined zone of reasonableness, and there is any resulting effect on consumer prices.

This asymmetric recasting of the public interest standard has no basis in judicial or FERC precedent and would render this Court's decisions of little or no practical value to sellers negotiating long-term contracts, and planning to make future investment decisions to support their contractual commitments. Long-term contracts, especially in times of shortage, would become far more risky and less likely to be undertaken. This would make it harder at such times for purchasers to secure stability of supply, and would make it more difficult to reduce short-term price volatility. Investments and other financial commitments needed to meet future needs would be impaired. And the uncertainties of the regulatory process would encourage litigation—by parties wishing to better their contractual position by challenging the rates that they have agreed to pay.

ARGUMENT

I. FERC PROPERLY CONCLUDED THAT MODIFICATION OF THE VALID, ARM'S-LENGTH CONTRACTS AT ISSUE WAS NOT REQUIRED BY, AND ACTUALLY WOULD IMPAIR, THE PUBLIC INTEREST

The agreements at issue were freely negotiated in good faith and at arm's length by sophisticated parties. FERC properly upheld these contracts under the public interest test.

A. The *Mobile-Sierra* Doctrine Provides That FERC May Undo A Valid Wholesale Energy Contract Only In Extraordinary Circumstances Where The Contract Is Contrary To The Public Interest

Sections 205 and 206 of the Federal Power Act expressly contemplate that rates will be set in the first instance by the utility—either through tariffs of general applicability, or through contracts governing specific transactions between buyers and sellers. *See* 16 U.S.C. §§ 824d(c), (d); 824e(a); *Verizon,* 535

U.S. at 479 (Congress, in the FPA, "acknowledged that contracts between commercial buyers and sellers could be used in ratesetting."). In *Mobile* and *Sierra*, this Court articulated the bedrock principle that "[t]he regulatory system created by the Act is premised on contractual agreements voluntarily devised by the regulated companies [and] it contemplates abrogation of these agreements only in circumstances of unequivocal public necessity." *In re Permian Basin Area Rate Cases*, 390 U.S. at 822 (discussing *Mobile* and *Sierra*).

Mobile made clear that upholding valid contracts serves the public interest. "[P]reserving the integrity of contracts," the Court explained, "permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry." 350 U.S. at 344. Moreover, the stable supply of energy depends on "substantial investments" that market participants cannot be expected to make "without long-term commitments," and such commitments are meaningless if "contracts are subject to unilateral change by [one party] whenever its interests so dictate." *Id.*

In *Sierra*, the Court observed that the purpose of Section 206(a) "is the protection of the public interest, as distinguished from the private interests of the utilities," such that "a contract may not be said to be either 'unjust' or 'unreasonable'" within the meaning of the Act "simply because it is unprofitable" to a private contracting party. 350 U.S. at 355; *see also Papago Tribal Util. Auth. v. FERC*, 723 F.2d 950, 953-54 (D.C. Cir. 1983) (Scalia, J.).

This Court in *Memphis* reaffirmed that the public interest is advanced by honoring private contracts, thereby upholding the interests of energy suppliers "in whose financial stability" consumers "ha[ve] a vital stake." 358 U.S. at 113. Otherwise, securing investments in energy infrastructure "would become most difficult, if not impossible." *Id.*

In *Verizon*, this Court recently explained that parties to wholesale contracts are typically "sophisticated businesses enjoying presumptively equal bargaining power," and thus can "be expected to negotiate a 'just and reasonable' rate as between the two of them." 535 U.S. at 479. Therefore, FERC's "principal regulatory responsibility was not to relieve a contracting party of an unreasonable [wholesale] rate" or to regulate retail rates, "but to protect against potential discrimination by favorable contract rates between allied businesses to the detriment of other wholesale consumers." *Id.*

The courts of appeals and FERC have likewise interpreted *Mobile* and *Sierra* in light of the bedrock principle that the FPA's respect for contracts must be preserved in order to ensure that the public enjoys reliable supplies of power. FERC has explained that "unprecedented and unforeseeable change in market circumstances" does not support abrogating a valid cost-based rate contract. *Pub. Serv. Co. of N.M.*, 43 FERC ¶ 61,469, at 62,145 (1988), *aff'd sub nom. San Diego Gas & Elec. Co. v. FERC*, 904 F.2d 727 (D.C. Cir. 1990). "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. *Id.* at 62,153.

Accordingly, the D.C. Circuit has explained that "the purpose of . . . contract[s] [i]s to allocate the risk of market price changes between the parties," such that a buyer's subsequent "conclusion that it got the mix wrong is no reason to allow it to shift the risk" back to the seller. *San Diego Gas & Elec. Co.*, 904 F.2d at 730. *See also Town of Norwood v. FERC*, 587 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."). FERC's "mandate is not to set the lowest possible rate" for retail consumers. *Pub. Serv. Co. of N.M.*, 43 FERC ¶ 61,469, at 62,152. Rather, FERC's ratemaking process "involves a balancing of the investor and the consumer interests." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). FERC and the courts therefore have recognized that the "claim that . . . [retail] ratepayers would derive benefit from a [wholesale] rate modification" is a "wholly inadequate" basis for abrogating a contract. *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403, 409 (D.C. Cir. 2000) ("*PEPCO*"). The guiding principle is thus that valid contracts should not be abrogated except in extraordinary circumstances because undermining the reliability of agreements "would have a chilling effect on the industry's willingness to contract," *Pub. Serv. Co. of N.M.*, 43 FERC ¶ 61,469, at 62,153, and as a result, "the market, the industry and ultimately the consumer would suffer." *San Diego Gas & Elec. Co.*, 904 F.2d at 730.

Although the *Mobile-Sierra* doctrine originated with claims by sellers who complained that a rate was too low, FERC and the courts of appeals have correctly observed that "purchasers can [also] make bargains which in hindsight prove improvident," *Boston Edison Co. v. FERC*, 856 F.2d 361, 372 (1st Cir. 1988), and when they do, "[e]xcept as the exigencies of the public interest demand[], the

Commission [is] no more at liberty to alter the . . . contract to the prejudice of the producers than to do so in their favor." *Pub. Serv. Comm'n of N.Y. v. FPC*, 543 F.2d 757, 798 (D.C. Cir. 1974).

For example, in *PEPCO*, 210 F.3d at 409, the D.C. Circuit affirmed FERC's refusal to reduce contractual rates because the complainant "fail[ed] to provide any evidence of undue discrimination or excessive burden, other than the disparity in rates and a bald claim that [the complainant's] ratepayers would derive benefit from a rate modification." Although the rate under the buyer's contract was twice the rate offered by the seller to other customers through its open access tariff, the D.C. Circuit reaffirmed its "consistent[] [view] that rate disparity . . . is not on that basis alone unduly discriminatory." *Id.* Moreover, the court reiterated the strong policy in favor of "contractual stability" and explained that "the fact that a contract has become uneconomic to one of the parties does not necessarily make the contract contrary to the public interest." *Id.* at 407-08. *See also Boston Edison Co. v. FERC*, 233 F.3d 60, 68 (1st Cir. 2000) (vacating an order reducing a rate charged by the seller where FERC "never found that the higher rates . . . were contrary to the public interest"); *cf. Papago*, 723 F.2d at 955.

B. The Commitment To Honor Contracts That Underlies The *Mobile-Sierra* Doctrine's Public Interest Test Is Vital To The Functioning Of The Wholesale Energy Markets Under FERC's Market-Based Rate Regime

The commitment to contract stability that underpins the *Mobile-Sierra* doctrine is even more critical to the functioning of energy markets under the modern regulatory regime than it was when this Court decided *Mobile* and *Sierra*.

Under the market-based rate regime, FERC authorizes a wholesale seller of electricity to sell at negotiated rates if FERC has first determined, after a thorough review of the market, that the seller "and its affiliates do not have, or adequately have mitigated, market power in the generation and transmission of . . . energy, and cannot erect other barriers to entry by potential competitors." *La. Energy & Power Auth. v. FERC*, 141 F.3d 364, 365 (D.C. Cir. 1998). FERC defines a seller's market power as that seller's ability to "significantly influence price in the market by withholding service and excluding competitors for a significant period of time." *Citizens*, 48 FERC ¶ 61,210, at 61,777.

A seller's application for market-based rate authority is open to public review and comment, and FERC's subsequent grant (or denial) of market-based authorization is subject to judicial review. *See, e.g.*, *Mont. Consumer Counsel*, 121 FERC ¶ 61,127. Moreover, following its initial finding of a lack of market power, FERC imposes numerous reporting requirements on authorized sellers to ensure the continued competitiveness of the market and the justness and reasonableness of market-based rates. For example, FERC requires each seller to file a market analysis every three years, and "quarterly reports summarizing its transactions during the preceding three months" (including, for each transaction, the names of the buyer and seller and the price, quantity, and duration of the contract at issue). *California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1013 (9th Cir. 2004); *Citizens*, 48 FERC

¶ 61,210, at 61,778. FERC retains the power to revoke a seller's market-based authorization if market conditions change. *See* 16 U.S.C. § 824e(a). FERC also has the authority to remedy tariff violations retroactively, such as by ordering disgorgement of profits. *See California ex rel. Lockyer v. British Columbia Power Exch. Corp.*, 100 FERC ¶ 61,295, at 62,334 (2002).

Lower courts have concluded (and no party to this case disputes) that FERC's market-based ratemaking regime comports with the FPA. *See Lockyer*, 383 F.3d at 1013; *La. Energy & Power Auth.*, 141 F.3d at 365; *see also Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870-71 (D.C. Cir. 1993) (Natural Gas Act). The "just and reasonable" requirement of the statute gives FERC "broad ratemaking authority" and "does not compel the Commission to use any single pricing formula." *Mobil Oil Exploration & Producing Se. Inc. v. United Distrib. Cos.*, 498 U.S. 211, 224 (1991).

As FERC properly recognized in its order setting the contract challenges for hearing, and in its brief to the Ninth Circuit, "[c]ompetitive power markets simply cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty, including certainty that the Commission will not modify market-based contracts unless there are extraordinary circumstances." Brief of the Federal Energy Regulatory Commission (9th Cir. Sept. 23, 2004); JA 1099a. The enforceability of contracts is critical in any market environment, but especially so in the market for electric power, which requires participants to commit to long-term investments in capacity, or to contracts for supplies and transmission, potentially costing billions of dollars. Without enforceable long-term contracts that ensure a return on their investments, market participants will either refuse to invest altogether, or will charge a risk premium that will ultimately be borne by consumers. *See Mobile*, 350 U.S. at 344 (explaining that parties cannot be expected to make "substantial investments . . . without long-term commitments," which are impossible if "supply contracts are subject to unilateral change"); *Memphis*, 358 U.S. at 113 (Absent stable contracts, "the maintenance and expansion of [energy] systems through equity and debt financing would become most difficult, if not impossible.").

Accordingly, it is extremely important that the *Mobile-Sierra* doctrine apply broadly to all contracts entered into in good faith by sellers found to lack market power, and thus authorized by FERC to engage in market-based ratemaking. The premise of the *Mobile-Sierra* doctrine is that "sophisticated businesses enjoying presumptively equal bargaining power" can be "expected to negotiate a 'just and reasonable' rate," *Verizon*, 535 U.S. at 479, the enforcement of which facilitates investment in energy markets and the stability of supply. This premise is fully applicable where parties who have received market-based rate authorization negotiate in good faith and reach an arm's-length agreement.

For this reason, the public interest test governs challenges to market-based rate contracts regardless of whether FERC required a prior filing and opportunity to review the contract at issue or whether a court believes FERC rules were sufficient to ensure that the markets were workably competitive when the contract was executed. While the contracts in *Mobile* and *Sierra* were filed with the respective agencies, this Court's reasoning in setting forth the public interest test did not invoke the agency's opportunity for initial review, but rather turned on the presumptive reasonableness of contracts as between the parties that negotiated them. [7] The Court deferred to the parties' agreements because it presumed that voluntary negotiations between sophisticated parties will produce just and reasonable rates. That presumption has even more force today, when competition has replaced the integrated vertical monopolies that controlled the energy markets when *Mobile* and *Sierra* were decided.

In any event, FERC's market-based regulatory scheme satisfies the statute's requirements. The FPA gives FERC broad latitude in providing for the filing of rates and charges with the Commission "within such time and in such form as the Commission may designate." 16 U.S.C. § 824d(c). The required filing of general market-based rate tariffs meets this requirement. The market rate authorization process requires FERC to analyze the market in depth before approving market-based

---

[7] The contracts at issue in *Mobile* and *Sierra* were "accepted" but never "approved" after initial review, as suggested by the Ninth Circuit. Pet. App. 39a. The applicable regulations—both then and now—expressly state that the "acceptance for filing of any tariff, contract or part thereof does not constitute approval by the Commission." 18 C.F.R. § 154.6 (2007); 18 C.F.R. § 154.23 (1949) (same). Moreover, both the D.C. and Fifth Circuits have rejected the notion that *Mobile-Sierra* applies only to contracts that have been filed and accepted. *Sam Rayburn Dam Elec. Coop. v. FPC*, 515 F.2d 998, 1008 (D.C. Cir. 1975); *Borough of Lansdale v. FPC*, 494 F.2d 1104, 1112 (D.C. Cir. 1974); *Natural Gas Pipeline Co. of Am. v. Harrington*, 246 F.2d 915, 919 (5th Cir. 1957).

ratemaking authority and requires authorized sellers to file quarterly reports of their transactions. *See Lockyer*, 383 F.3d at 1013; *La. Energy & Power Auth.*, 141 F.3d at 365. Requiring market-based rate contracts to also be filed immediately with FERC and subjected to plenary review would render the Commission's initial inquiry into market power futile and make it impossible for market participants to immediately lock in freely negotiated rates, terms, and conditions of service before market conditions shift.

The application of the *Mobile-Sierra* doctrine to these market-based rate contracts means that such agreements may be set aside only when doing so is required to protect the public interest. In that assessment of the public interest, the considerations set forth by this Court in *Sierra* provide a starting point for FERC's analysis and demonstrate that contract modification is only warranted in the most extraordinary circumstances. *See Sierra*, 350 U.S. at 355 (setting forth, as illustrations of legitimate public interest concerns, whether the contract at issue "might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory"). Most important in a case involving market-based rates is the public's overwhelming interest in honoring valid contracts agreed upon by market participants. Modifying the rates in such contracts in any but the most extraordinary circumstances would severely harm the public interest by disturbing the settled expectations of market participants, discouraging investment in the energy markets, and ultimately increasing the cost of energy—or, worse yet, disrupting the reliable supply of energy—for retail consumers.

C. FERC Properly Applied The *Mobile-Sierra* Doctrine To This Case And Correctly Recognized That Abrogating These Agreements Would Contravene The Public Interest By Destabilizing Wholesale Energy Markets

FERC properly applied the governing law (1) in following the intent of the parties and finding the *Mobile-Sierra* presumption of contract validity applicable in this case; and (2) in concluding that the doctrine's public interest analysis requires that the contracts at issue be upheld.

1. FERC acted properly in concluding that the *Mobile-Sierra* doctrine applies, based on its assessment of the intent of the parties (with which the court below agreed), and its finding that there was no evidence of fraud, bad faith, duress, or market power in the negotiation of these contracts. Pet. App. 297a, 299a, 301a. FERC found that both the Nevada Companies and SCWC had ample alternatives from other suppliers, yet they chose to enter into these contracts with Petitioners. Pet. App. 298a, 300a-301a. The Commission also observed that the Nevada Companies and SCWC had handsomely profited on the front end of their contracts by reselling the power they received pursuant to these contracts at much higher prices to third parties or back to Petitioners. Pet. App. 252a, 300a.

FERC concluded that in both instances, Complainants had simply made risk allocation decisions that over time proved unattractive to them: the Nevada Companies "failed to hedge for the possible risk that . . . prices might fall," Pet. App. 297a, and SCWC knew that prices were falling (and negotiated a rate that was lower than the expected future spot market price), but did not anticipate the extent of the fall. Pet. App. 300a. In short, FERC concluded that Complainants had merely become dissatisfied with the results of contracts that they had knowingly and voluntarily executed. Pet. App. 301a.

On the basis of those findings, the *Mobile-Sierra* presumption of contract validity was properly applied, without regard to any impact that spot market dysfunction could conceivably have had on forward prices.

2. In its application of the *Mobile-Sierra* doctrine, FERC also properly found that the applicable public interest test weighs overwhelmingly in favor of upholding the contracts.

None of the three *Sierra* considerations regarding the public interest support modifying these contracts. *First*, FERC correctly determined that the Nevada Companies had not shown that the contract rates "might impair the financial ability of the [purchasers] to continue [their] service." *Sierra*, 350 U.S. at 355. FERC found that there was no evidence that the contracts at issue placed either the Nevada Companies or SCWC in financial distress. Pet. App. 293a-295a. SCWC had actually profited from its resale of energy supplied by the Mirant contract in the spring of 2001. Pet. App. 295a. To the extent the Nevada Companies suffered financial hardship at all, FERC found that their financial distress pre-dated the contracts at issue here, and any additional distress was attributed to the effects of other contracts. Pet. App. 294a. Clearly, there was no danger that the financial health of either the Nevada Companies or SCWC would lead to an interruption or impairment of energy supplies so as to justify abrogation of the parties' contracts.

Second, FERC properly concluded that none of the contract rates "cast upon other consumers an excessive burden." *Sierra*, 350 U.S. at 355. It noted that the Nevada Companies were projecting rate decreases of approximately 20 percent for their retail customers. Pet. App. 294a. Similarly, no excessive burden was placed on SCWC's ratepayers. Those who were permanent residents in their service area experienced no change in their rates, while those who owned second homes in the area faced average monthly bills of only $35.13. Pet. App. 295a. In all events, it is not the Commission's mandate to "set the lowest possible rate," *Pub. Serv. Co. of N.M.*, 43 FERC ¶ 61,469, at 62,152, particularly in light of the harm to the public interest from disturbing valid agreements.

Third, neither the Nevada Companies nor SCWC demonstrated that the contract rates were "unduly discriminatory" between wholesale customers. *Sierra*, 350 U.S. at 355; Pet. App. 296a.

Moreover, FERC's review also took into account the "totality of circumstances" surrounding the negotiation of the contracts. Pet. App. 296a-300a. That review made clear that the forward markets in which these contracts were executed were fully competitive, and the parties contracting in the forward markets were merely responding with good-faith, investment-backed, long-term commitments based on the world as they knew it at the time.

To the extent forward prices were influenced by current expectations about continuing high spot market prices, the parties executing forward contracts assumed risk in return for potential benefits. The buyers, seeking price stability over the long run and immediate rate relief from the far higher prices in the spot markets, ran the risk that spot market prices would decline, making their forward contracts less economical. The sellers, often selling at a loss early in the contracts, stood to benefit if prices declined, but took the risk that spot market prices would remain flat or increase over time.

Invalidating these contracts now on the ground that the spot market for energy was dysfunctional when these forward contracts were signed—a possibility that was under public investigation by FERC at the time—would grossly undermine the reliability of all contracts, and the willingness of market participants to make essential long-term investments. *See Sierra*, 350 U.S. at 355 (concluding that post-contract increase in energy prices caused by reduction in capacity at Shasta Dam did not support abrogating long-term contract entered into at a lower rate); *San Diego Gas & Elec. Co.*, 904 F.2d at 730 (noting that buyer's "current conclusion that it got the mix wrong is no reason to allow it to shift the risk" back to seller); *Town of Norwood*, 587 F.2d at 1312 (explaining that parties must "live with their bargains as time passes and various projections about the future are proved correct or incorrect").

Indeed, whatever short-term benefit the public might realize if retail rates were lowered as a result of modifying the wholesale contracts in this case would be far outweighed by the long-term harm to the public interest that unsettling the expectations of market participants and destabilizing the energy markets would cause.

Moreover, the Commission has a panoply of other tools to address the problem of market manipulation by third parties. FERC may suspend or limit market-based rate authorization prospectively if market conditions change. *See* 16 U.S.C. § 824e(a). It may redress violations of reporting and other regulatory requirements by authorized sellers by ordering disgorgement of profits. *See Lockyer*, 100 FERC ¶ 61,295, at 62,334. These tools, plus others since added,[8] provide appropriate means to address any legitimate concerns about market manipulation. Invalidating freely negotiated contracts entered into by parties who engaged in no misconduct with respect to those contracts would contravene rather than advance the public interest.

[8] Under the Energy Policy Act of 2005, the Commission also has the authority to impose civil penalties of up to $1 million per day for any entity that uses any "manipulative or deceptive device or contrivance" in the purchase or sale of electric energy. *See* 16 U.S.C. §§ 824v, 825o-1. *See also CAlifornians for Renewable Energy, Inc. v. Ca. Pub. Utils. Comm'n*, 119 FERC ¶ 61,058, at PP. 32, 35, 37 (2007) (describing the Commission's "Office of Enforcement," which applies new "Market Behavior Rules" that "set guidelines for the conduct of sellers with market-based rate authority, and provide[] remedies for manipulative behavior and other market abuses by such sellers").

II. THE NINTH CIRCUIT'S REVISION OF THE *MOBILE-SIERRA* DOCTRINE WOULD CREATE HARMFUL UNCERTAINTY ABOUT THE ULTIMATE ENFORCE-ABILITY OF CONTRACTS, AND THUS DISCOURAGE INVESTMENT NEEDED TO MEET FUTURE ENERGY NEEDS

The Ninth Circuit required two critical modifications of the *Mobile-Sierra* doctrine, as applied to FERC's current regulatory regime, which contravene this Court's precedents and would cause profound harm to energy markets and ultimately to energy consumers. *First*, the Ninth Circuit held that in order for the *Mobile-Sierra* doctrine to apply, it is not enough for FERC to conduct an initial review of the market power of power sellers before authorizing them to sell at market prices. It must conduct an ongoing review that guarantees the reasonableness of contracted prices and review the operation of individual contracts retrospectively, in the context of the overall market, to determine whether the circumstances present at the time of their formation indicated that prices negotiated may have been influenced by market dysfunction. *See* Pet. App. 41a-42a, 55a. *Second*, the Ninth Circuit ruled that, assuming the *Mobile-Sierra* doctrine and its public interest standard are found to be applicable, the application of the standard must be asymmetrical, requiring demonstration of "an excessive burden" on consumers if a seller challenges the terms of a contract, but requiring only that consumers have paid a "higher" rate that fell outside the "zone of reasonableness" where a buyer challenges the terms of a contract. Pet. App. 63a-64a.

A. The Ninth Circuit's Requirement Of Retrospective FERC Review Of Contracts Is Inconsistent With The *Mobile-Sierra* Doctrine And Would Have Several Deleterious Consequences

The Ninth Circuit ruled that FERC is not only required to ensure that market participants lack market power at the time of contract formation, but also to examine "whether the original negotiations occurred in a functional marketplace such that we may presume the contracted rates were originally just and reasonable." Pet. App. 42a. The Ninth Circuit made clear that such review could not be "purely prospective," but would have to retrospectively "permit[] consideration of the market conditions at the time a challenged forward contract was entered." Pet. App. 52a. The court broadly understood "market conditions" to include any "improper factor[]," including "market manipulation, the leverage of market power, or an otherwise dysfunctional market." Pet. App. 57a. As explained in its companion *Public Utilities Commission of California* decision, under the Ninth Circuit's new prerequisites, virtually any long-term contract could be open to question, if prices later fall, because facts suggesting "improper factors" in the forward market or a related market at the time of contracting could later come to light. Pet. App. 375a-376a.

This sweeping retrospective reconsideration of contracts that the Ninth Circuit envisioned cannot be reconciled with *Mobile* and *Sierra*. In *Sierra*, this Court rejected a seller's effort to set aside a contract after the aberrational nature of the market conditions at the time the contract was negotiated became apparent (due to the availability of excess capacity at Shasta Dam that later diminished). 350 U.S. at 352-54. The Court recognized that such retrospective second-guessing of contract rates is inimical to the long-term financial commitments required to satisfy the energy needs of the Nation. *See Mobile*, 350 U.S. at 344. The Ninth Circuit's rule calls for precisely the sort of hindsight review of the market "context" and any potential "dysfunction[]," Pet. App. 57a, 59a, that this Court has rejected. Indeed, it is well established that a party cannot renege on its agreement to apply *Mobile-Sierra* (and thus preclude unilateral rate changes) by arguing that hindsight has revealed flaws in the cost estimates initially included in the parties' filing. *See, e.g.*, *San Diego Gas & Elec. Co.*, 904 F.2d at 730. There is no reason for a different result here.

The Ninth Circuit's contemplated retrospective reexamination of contracts would be particularly harmful in the market-based rate context. *First*, it would discourage the formation of long-term contracts. Based on contract commitments from buyers, sellers of electric power typically make corresponding commitments in infrastructure investments or undertake significant contract commitments of their own to enable them to generate or otherwise obtain the power they have contracted to provide. The substantial commitments that sellers undertake to fulfill their contracts may include building or operating generation facilities, contracting to buy firm power from other sellers, purchasing generating fuel, purchasing transmission services, or hedging electricity costs through futures, options, or financial instruments.

Under *Mobile* and *Sierra*, a seller of energy has had the ability, by proper conduct based on information reasonably available to it, to all but eliminate the risk that its contractual obligations will be modified by subsequent government fiat. To obtain that certainty, the seller must satisfy FERC's initial conditions for securing market-based ratemaking authority; comply with applicable FERC filing requirements; avoid fraud, duress, or bad faith; and execute a forward contract that fixes the price without an express right to modification.

The Ninth Circuit's rule would replace that certainty with instability. Under the Ninth Circuit's approach, the enforceability of a contract turns on *post hoc* agency review of the market "context," Pet. App. 59a, a factor that is beyond the control of—and may well not be discernible to—an innocent seller, *i.e.*, whether the forward market or some related market was in some way "dysfunctional" when the contract was originally formed. Pet. App. 57a (asserting that *Mobile-Sierra* cannot apply without a determination that the challenged contract was formed "free from the influence" of "an otherwise dysfunctional market"). Thus, under the Ninth Circuit's new rule, a sophisticated seller executing market-based rate contracts in good faith with sophisticated buyers cannot reasonably rely on its contracts when making business and investment decisions.

Second, and as a direct consequence, the Ninth Circuit's rule would ultimately harm consumers by increasing market volatility, because it would discourage the use of long-term forward contracts. In situations where market volatility has driven up the prices in short-term or "spot" markets as was the case here, long-term forward contracts can decrease volatility and increase stability. Purchasers of power under such contracts can hedge against the possibility that high prices will continue or even increase by purchasing power at fixed prices over a long period of time. Sellers of power can hedge against the possibility that high prices will decrease by selling power over a long period of time. In this context, long-term contracts will aid consumers by leading to more stable energy markets, and ultimately will keep prices in check. But where long-term contracts are subject to modification, the incentives to enter such contracts will decrease dramatically, reducing the chances of stabilizing markets and ultimately reducing economic restraints on high prices. Ironically, the Ninth Circuit's reworking of *Mobile-Sierra* would substantially undermine perhaps the most effective mechanism to address market volatility.

Third, the Ninth Circuit's rule would undermine the incentives to produce additional electric power precisely when it is most needed to respond to shortages. When supplies of power are tight, prices typically rise significantly. In such high-price environments, power providers have strong incentives to produce and transport more power, which in turn alleviates shortages and drives prices downward. But under the Ninth Circuit's rule, high-price environments are the circumstances likely to lead to strict review of contracts and the increased likelihood of contract modifications. Such high-price environments are the most likely to be retrospectively deemed "dysfunctional" under the Ninth Circuit's reasoning. Perceiving that, at the times of greatest need, power sellers would be discouraged from producing greater amounts of power, and making the correspondingly extensive investments necessary for such production.

Fourth, litigation and transaction costs would rise substantially. The decision below invites widespread litigation whenever market prices decline from previous higher levels—a common occurrence that reflects the interaction of supply and demand. The Nevada Companies alone sought to abrogate or amend two hundred contracts in the proceedings below. Pet. App. 30a. Indeed, such litigation would likely focus on the amorphous issue of whether a market relevant to price formation in the forward market was "dysfunctional" when the contract was formed. That issue would require significant examination of whether a market is relevant and, if so, of the market forces, the effects of regulation, and the conduct of numerous market participants in that market. It would also require the after-the-fact determination of the effects of any market "dysfunction" that existed. Furthermore, such litigation would not resolve the matter, because any FERC findings could be revisited later if new evidence about the market were to emerge. *See* Pet. App. 375a-376a. Such litigation is likely to be widespread, expensive, and time-consuming, to the detriment of consumers.

B. The Ninth Circuit's Asymmetric Approach To "Public Interest" Analysis Means That Even Where *Mobile-Sierra* Applies, It Provides Little Protection To Contracts Challenged Based On Assertions That The Price Was Unreasonably High

Even in those limited circumstances where the Ninth Circuit would agree that the *Mobile-Sierra* presumption of contract validity applies, the court erroneously held that the presumption applies differently depending on whether the contract rate is challenged by a buyer or a seller. The court declared that sellers' ability to escape contractual obligations continues to be governed by the demanding *Sierra* standard—whether the contract will "adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." 350 U.S. at 355. *See* Pet. App. 63a. The Ninth Circuit would, however, permit buyers to escape contractual obligations "if a challenged contract imposes any significant cost on ultimate customers because of a wholesale rate too high to be within a zone of reasonableness." Pet. App. 63a-64a. Under these rules, *Mobile-Sierra*—once found to apply—provides very little protection to sellers of power.

The "zone of reasonableness" test set forth by the Ninth Circuit for challenges raised by buyers appears to require the very same kind of analysis that FERC performs when the public interest standard does not apply. *See* Pet. App. 64a (requiring FERC to examine contracts as if "the challenged contracts called for rates within the just and reasonable range") and Pet. App. 65a (stating its standard "mirrors that endorsed by the D.C. Circuit for determination of a just and reasonable rate under a market-based rate regulation regime"). Indeed, the court apparently contemplated that the zone of reasonableness for market-based rates would be determined by comparing the contract rate to marginal cost, *see* Pet. App. 64a, a benchmark that will bear little relation to the competitive market price prevailing when a contract is executed, especially if the contract is executed during a period of scarcity.

An asymmetric analysis that treats buyers and sellers differently makes no sense and would work to destabilize the energy markets. In *Sierra*, this Court refused to permit FERC to "relieve[]" a seller "of its improvident bargain." 350 U.S. at 355. The Court's reasoning should apply equally to buyers. As the First Circuit has explained, it is "logically inferable" that both sellers and "purchasers can make bargains which in hindsight prove improvident." *Boston Edison*, 856 F.2d at 372. The FPA contains no special contractual protections for buyers, and the Ninth Circuit's construction of the statute to grant buyers more favorable post-contract remedies destroys the "symmetry [of] the ratemaking process." *Id.*

Indeed, the market "dysfunction" that gave rise to the price increases in the California spot market resulted from (1) unusually high demand for electricity, combined with a scarcity of generation capacity, (2) buyers' excessive reliance on spot-market purchases, due to regulatory requirements, and (3) illegal manipulation of spot-market prices by certain participants in that market. *See* Pet. App. 23a-25a. These market conditions equally affected buyers and sellers in the forward markets. The Ninth Circuit's asymmetric public interest standard reflects an irrational preference for buyers over sellers, though all may be equally innocent of market manipulation or other impropriety.

Moreover, the Ninth Circuit's approach ignores the role that marketers play in wholesale power markets. Power marketers, which include

Petitioners, meet their sales obligations by buying power in the same forward markets potentially affected by "dysfunctional" spot markets in order to fulfill their obligations to supply power to Complainants. Absent bad faith, duress, fraud, or other manipulative conduct with respect to the particular contracts at issue, these power marketers should be able to rely on their contracts.

The Ninth Circuit's asymmetric analysis is particularly troubling with respect to its effect on long-term contracts, which make a major contribution to price stability. Under the Ninth Circuit's rule, sellers face the risk that if market prices decline during the term of the contract they may lose the benefit of the contract price because the buyer may be able to secure a price reduction by convincing FERC that a relevant market was "dysfunctional" at the time of contract formation. However, if market prices rise during the life of the contract, the seller will be locked into the unfavorable contract terms. This asymmetry is far less pronounced with respect to short-term contracts under which there is much less time for price fluctuations to occur. Therefore, the Ninth Circuit's rule will have the harmful effect of encouraging short-term contracts and discouraging long-term contracts. As the facts of this case demonstrate, such incentives undermine market stability and consumer welfare.

In the end, the Ninth Circuit's articulation of the public interest test entirely guts the *Mobile-Sierra* doctrine. Instead of calling upon FERC to evaluate the relative benefits to a buyer and seller who formed a freely negotiated, arm's-length contract only where the contract so requires, the Ninth

Circuit mandates that FERC undertake such an analysis whenever in retrospect it appears that some dysfunction affected the market. If FERC concludes that market dysfunction—whatever that may include—caused the parties to agree to a rate that FERC later deems unreasonably high, the seller loses the benefit of its bargain if consumers have paid any significant additional amount for power following the contract. Such a regime would provide no comfort to sellers that their contracts will be honored and, if allowed to stand, would dramatically undermine the stability of the energy markets.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

ROBERT F. SHAPIRO
MERRILL L. KRAMER
CHADBOURNE & PARKE LLP
1200 New Hampshire Avenue, N.W.
Washington, D.C. 20036
(202) 974-5600
Counsel for Petitioner Allegheny Energy Supply Company, LLC

KEITH R. MCCREA
KENT L. JONES
WILLIAM H. PENNIMAN
SUTHERLAND ASBILL & BRENNAN LLP
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-0100
Counsel for Petitioner Calpine Energy Services, L.P.

DONALD B. AYER
(COUNSEL OF RECORD)
CLARK EVANS DOWNS
LAWRENCE D. ROSENBERG
KENNETH B. DRIVER
SHAY DVORETZKY
JULIET J. KARASTELEV
JONES DAY
51 Louisiana Avenue, N.W.
Washington, D.C. 20001
(202) 879-3939
Counsel for Petitioner American Electric Power Service Corp.

MICHAEL J. GERGEN
JARED W. JOHNSON
LATHAM & WATKINS LLP
555 Eleventh Street, N.W.
Washington, D.C. 20004
(202) 637-2200
Counsel for Respondent (in support of Petitioners) Mirant Energy Trading, LLC

November 21, 2007