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No. 08-674

IN THE
# Supreme Court of the United States

NRG POWER MARKETING, LLC, ET AL.,
*Petitioners*,
v.
MAINE PUBLIC UTILITIES COMMISSION, ET AL.,
*Respondents*.

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

## BRIEF OF COLIN C. BLAYDON, CHARLES J. CICCHETTI, JEFFREY A. DUBIN, A.J. GOULDING, WILLIAM W. HOGAN, JOSEPH P. KALT, PAUL R. KLEINDORFER, ROBERT J. MICHAELS, CRAIG PIRRONG, VERNON L. SMITH, JAMES L. SWEENEY AND ROBERT D. WILLIG AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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## QUESTION PRESENTED

Whether the D.C. Circuit erred in holding that the *Mobile-Sierra* doctrine—which prohibits the Federal Energy Regulatory Commission from modifying or abrogating electricity and natural gas contracts unless they are shown to be contrary to the public interest—is inapplicable when a contract is challenged by a non-contracting third party.

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## INTEREST OF AMICI[1]

*Amici* are leading professors and scholars who teach and write on economic issues. Many of them have researched and published analyses of the economics of the electricity industry. Several have also testified in various proceedings about the nature, structure, and appropriate regulation of electricity markets. Certain of the *amici* filed a brief in support of petitioners in *Morgan Stanley Capital Group Inc. v. Public Utility District No. 1 of Snohomish County*, 128 S. Ct. 2733 (2008), explaining that, if not overturned, the Ninth Circuit's decision at issue in that case would erode the contract certainty that plays a crucial role in the proper functioning of the wholesale energy markets.[2] *Amici* are similarly concerned that the decision below will result in long-term harm to the energy markets by impeding the ability of market participants to enter into and rely on contracts.

A summary of the *amici's* qualifications and affiliations is provided as an appendix to this brief. *See*

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[1] The parties have consented to the filing of this brief: a letter of consent from the Solicitor General has been filed herewith and blanket letters of consent were filed with this Court on July 10, 2009 by counsel for the other parties. No counsel for a party authored this brief in whole or in part, and no such counsel or any party made a monetary contribution intended to fund the preparation or submission of the brief. Counsel's fees and expenses incurred to prepare this brief were paid by American Electric Power Service Corp., Iberdrola Renewables, Inc., Powerex Corp., Sempra Generation, Shell Energy North America (US), L.P., and TransCanada Energy Ltd. No other person or entity made a monetary contribution intended to fund the preparation or submission of this brief.

[2] *See* Brief of William J. Baumol *et al.*, as *Amici Curiae* in Support of Petitioners, Nos. 06-1457, 06-1462 (filed Nov. 28, 2007).

App., *infra*, at 1a. *Amici* file this brief as individuals, not on behalf of the institutions with which they are affiliated. None of the *amici* is being compensated in connection with this brief.

## SUMMARY OF ARGUMENT

Economists have long recognized that contract stability is essential to the health of the energy industry. Buyers and sellers alike in the wholesale energy markets rely on fixed-price, long-term contracts to insulate themselves against price fluctuations and changing market conditions. This encourages and undergirds investment. The energy industry requires large infusions of capital to build generating and transmission facilities to meet demand, and contracts provide developers, producers and lenders with assured revenue streams that are necessary for investment.

This Court made these same points last year in *Morgan Stanley*. It explained that contracts are a "key source of stability" in the energy industry, and that "'uncertainties regarding rate stability and contract sanctity can have a chilling effect on investments and a seller's willingness to enter into long-term contracts,'" which will "'harm customers in the long run.'" 128 S. Ct. at 2749 (citation omitted). The Court confirmed the continuing vitality of the *Mobile-Sierra* doctrine,[3]

[3] The *Mobile-Sierra* doctrine takes its name from this Court's decisions 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). *Mobile* involved the Natural Gas Act ("NGA"), while *Sierra* involved the Federal Power Act ("FPA"). Because the relevant provisions of the NGA and FPA are "substantially identical," 350 U.S. at 353, the Court has "cite[d] interchangeably

which is "grounded in the commonsense notion that 'in wholesale markets, the party charging the rate and the party charged [are] often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a "just and reasonable" rate as between the two of them.'" *Id.* at 2746 (quoting *Verizon Commc'ns Inc. v. FCC*, 535 U.S. 467, 479 (2002)) (alterations in original). And it reaffirmed that, as a consequence of the presumptive justness and reasonableness of contracts, under *Mobile-Sierra* the Federal Energy Regulatory Commission ("FERC") has no power to modify a "mutually agreed-upon contract rate" unless the rate "seriously harms the consuming public." *Id.*

This Court's decisions in *Mobile*, *Sierra* and *Morgan Stanley* assure participants in the wholesale energy markets that their contracts will be enforced except in rare "circumstances of unequivocal public necessity." *Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968). The regulatory scheme thereby strikes a necessary and appropriate balance: contracting parties transact secure in the knowledge that their bargains will be enforced in all but the most extraordinary circumstances, and consumers are at the same time protected by contracts that provide rate stability and support infrastructure investments and by FERC's ability to override a contract if it "harms the public interest." *Morgan Stanley*, 128 S. Ct. at 2747.

The rule announced by the D.C. Circuit in this case would disrupt that careful balance, destroy the

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decisions interpreting the pertinent sections of the two statutes." *Ark. La. Gas Co. v. Hall*, 453 U.S. 571, 577 n.7 (1981).

contract certainty long fostered by *Mobile-Sierra*, and threaten the health and stability of the energy industry on which the public relies. The D.C. Circuit held that a contract that would be presumed reasonable under the FPA in any challenge by a contracting party loses that presumption if the challenge is instead mounted by a third party, and that third-party challenges are subject to review under the less deferential "'ordinary' 'just and reasonable'" standard that the Commission applies to unilateral rate filings. *Morgan Stanley*, 128 S. Ct. at 2740 (citation omitted). This third-party exception to *Mobile-Sierra* would as a practical matter swallow the rule because an incredibly wide range of third parties—including retail consumers, consumer advocacy groups, and state and local government bodies acting for their constituents—are typically affected by, and thus would have the incentive and standing to challenge, the wholesale contracts for electricity that the Commission regulates.

Reliable contract enforcement is crucial to economic growth and development because contracts provide the most efficient way for parties to allocate the risk of uncertain future market conditions between themselves in a manner that benefits them *and society as a whole*. The D.C. Circuit's third-party exception to the *Mobile-Sierra* presumption is inconsistent with that basic understanding. By empowering all third parties, even those not involved in initial contract negotiations and only indirectly affected by contract terms, to retroactively undo wholesale contracts, the D.C. Circuit's holding will undermine contracting parties' ability to reach bargains in the first instance. And parties' inability efficiently to allocate risk in the long run will increase prices and stifle necessary

investments in needed energy infrastructure, injuring the very public welfare that the statute is intended to safeguard. The same economic rationales that are manifest in *Mobile*, *Sierra*, and *Morgan Stanley* require contracts to be enforced as agreed to by the contracting parties, regardless of whom might later seek to undo them, except when absolutely necessary to protect the public.

## ARGUMENT

### I. THE *MOBILE-SIERRA* DOCTRINE PROVIDES CONTRACTUAL CERTAINTY CRUCIAL TO THE HEALTH OF THE ELECTRICAL POWER INDUSTRY

Economists have long understood that the law must consistently and predictably enforce the rights and obligations of contracts in order to foster economic development.[4] Parties' ability to rely on contract enforcement is especially crucial in the inherently volatile wholesale electricity markets. Hany A. Shakwy *et al.*, *A First Look at the Empirical Relation*

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[4] *See, e.g.*, Adam Smith, *The Wealth of Nations* 133 (Edwin Cannan ed., Bantam Dell 2003) (1776) ("When the law does not enforce the performance of contracts, it puts all borrowers nearly upon the same footing with bankrupts …."); Daniel Kaufman *et al.*, World Bank Policy Research Working Paper No. 2196, *Governance Matters* 8, 12 (Oct. 1999) (contract enforceability a key component of the "rule of law," which is critical to economic development); Ross Levine, *The Legal Environment, Banks and Long-Run Economic Growth*, 30 J. Money, Credit and Banking 596, 610-11 (1998) (contract enforceability facilitates the development of efficient banking systems necessary for economic growth); *see also Am. Airlines, Inc. v. Wolens*, 513 U.S. 219, 230 (1995) ("Market efficiency requires effective means to enforce private agreements.").

*Between Spot and Futures Electricity Prices in the United States*, 23 J. Futures Mkts. 931, 932 (2003). Because electricity cannot be stored, spot prices are vulnerable to spikes in demand. Indeed, a "properly-functioning, fully-competitive electricity market is likely to yield market prices that vary by a factor of ten or twenty to one in a single day." Richard J. Pierce, Jr., *How Will the California Debacle Affect Energy Deregulation?*, 54 Admin. L. Rev. 389, 395 (2002); *see also* Francis A. Longstaff & Ashley W. Wang, *Electricity Forward Prices: A High-Frequency Empirical Analysis*, 59 J. Fin. 1877, 1877 (2004) (lack of storage capability makes electricity vulnerable to price fluctuations); Energy Information Administration, U.S. Dep't of Energy, *Derivatives and Risk Management in the Petroleum, Natural Gas and Electricity Industries* 1 (Oct. 2002) ("[E]nergy prices are among the most volatile of all commodities ....").[5] Long-term contracts allow participants in the electricity markets to manage efficiently the risks associated with that extreme volatility.

More particularly, long-term contracts assure buyers of steady supplies at fixed or stable costs, allowing them to avoid exposure to unpredictable spot prices. *See* John C. Hull, *Options, Futures, and Other Derivatives* 9-10 (6th ed. 2006). At the same time, long-term contracts give sellers the certainty and stability necessary to incentivize optimal investments in our power infrastructure. The electric industry is "inherently capital-intensive." Amy Abel, CRS Report for Congress, *Electric Transmission: Approaches for*

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[5] *Available at* http://www.eia.doe.gov/oiaf/servicerpt/derivative/.

*Energizing a Sagging Industry* 1 (Oct. 2007).[6] The building or upgrading of electric generating and transmission facilities often requires hundreds of millions of dollars. Once such capital is invested, "the resulting assets are typically immobile and suitable only to a single purpose," and the investor therefore "cannot easily exit the business without losing these massive sunk costs." William P. Barr *et al.*, *The Gild That Is Killing the Lily: How Confusion Over Regulatory Takings Doctrine Is Undermining the Core Protections of the Takings Clause*, Geo. Wash. L. Rev. 429, 441-42 (2005). Long-term contracts encourage investment by reducing developers' and lenders' risks that they will fail to recoup their investments over time. By agreeing to long-term contracts, both buyers and sellers are able to hedge against future uncertainty by locking-in stable prices.

The volatility that encourages parties to enter into contracts in the first instance may of course result in a contracting party later being "out-of-the-money," with an incentive to seek to overturn the bargain. Knowing that, parties will not enter into contracts unless they are confident that the law will uphold their agreements in the face of changing and unpredictable market conditions. Economists have thus emphasized the importance of regulatory certainty to the continued development of the industry. *See, e.g.*, Mario Bergara *et al.*, *Political Institutions and Electric Utility Investment: A Cross-Nation Analysis*, 40 Cal. Mgmt. Rev. 18, 19-20 (1998); Mark A. Jamison *et al.*, *Measuring and Mitigating Regulatory Risk in Private*

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[6] *Available at* http://ncseonline.org/NLE/CRSreports/06Oct/RL32075.pdf

*Infrastructure Investment*, 18 Elec. J. 36, 37 (2005); Pablo T. Spiller, *A Positive Political Theory of Regulatory Instruments: Contracts, Administrative Law or Regulatory Specificity?*, 69 S. Cal. L. Rev. 477, 482-83 (1996). As the D.C. Circuit previously recognized, "'[t]he certainty and stability which stems from contract performance and enforcement is essential to an orderly bulk power market. If the integrity of contracts is undermined, business would be transacted without legally enforceable assurances and we believe that the market, the industry and ultimately the consumer would suffer.'" *San Diego Gas & Elec. Co. v. FERC*, 904 F.2d 727, 730 (D.C. Cir. 1990) (citation omitted).

Congress appreciated these dynamics and enacted a regulatory scheme that accommodates the freedom and obligations of contract. The FPA "evince[d] no purpose to abrogate private rate contracts as such," *Mobile*, 350 U.S. at 338, and left unchanged the powers of public utilities "to establish *ex parte*, and change at will, the rates offered to prospective customers; or to fix by contract, and change only by mutual agreement, the rate agreed upon with a particular customer." *Id.* at 343. Although the FPA requires that all rates for electricity be "just and reasonable," 16 U.S.C. § 824e(a), rates set by contract require a "differing *application*" of the just and reasonable standard. *Morgan Stanley*, 128 S. Ct. at 2740. Under the *Mobile-Sierra* doctrine, contract rates are presumed to be just and reasonable, and that presumption may be overcome only if the rate "seriously harms the consuming public." *Id.* at 2746; *see also Sierra*, 350 U.S. at 355 (Commission may only modify a rate that "adversely affect[s] the public interest"). In this way,

the Act is interpreted to "afford[] a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other." *Mobile*, 350 U.S. at 344. By establishing a "high" standard for regulatory modification of contracts, *Morgan Stanley*, 128 S. Ct. at 2749 n.6, the *Mobile-Sierra* doctrine provides the regulatory certainty that is necessary to support the efforts of market participants to allocate risks between themselves by contract.

## II. THERE IS NO ECONOMIC BASIS FOR A THIRD-PARTY EXCEPTION TO THE *MOBILE-SIERRA* PUBLIC INTEREST STANDARD

In *Morgan Stanley*, this Court affirmed the centrality of *Mobile-Sierra*'s presumption of reasonableness to the FPA's regulatory scheme. *See* 128 S. Ct. at 2749 ("The FPA recognizes that contract stability ultimately benefits consumers, even if short-term rates for a subset of the public might be high by historical standards ...."). The D.C. Circuit's decision below would effectively eliminate that presumption. The D.C. Circuit held unequivocally that "the *Mobile-Sierra* doctrine *simply does not apply*" in any circumstances where "a rate challenge is brought by a non-contracting third party." Pet. App. 22a (emphasis added).

The D.C. Circuit's decision to exempt all third parties from the *Mobile-Sierra* presumption apparently stems from two related erroneous beliefs: first, that a wholesale contract that is presumptively reasonable as between the parties because of the "superior efficiency

of private bargaining" (Pet. App. 19a) is not presumptively reasonable as to third parties; and, second, that the application of the *Mobile-Sierra* presumption to third parties deprives them of their right to a just and reasonable rate. Pet. App. 22a. In so holding, the court of appeals ignored both the underlying economic rationale for freedom of contract and the fact that the *Mobile-Sierra* public interest standard is constructed precisely to permit FERC to modify contract rates when necessary to protect the interest of non-contracting third parties.

Contract law and economic theories of contract rest on the common understanding that, because of the efficiency of private bargaining, buyers and sellers are able to negotiate contracts that maximize gains not only for themselves but also for society as a whole. *See, e.g.*, Anthony T. Kronman & Richard A. Posner, *The Economics of Contract Law* 2 (1979) (voluntary exchanges "facilitate[] the allocation of the good or service in question to the use in which it is most valuable, thereby maximizing the wealth of society"); Richard A. Posner, *Economic Analysis of Law* 14 (4th ed. 1992) ("Where resources are shifted pursuant to" a contract, "we can be reasonably sure that the shift involves an increase in efficiency."); Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 Yale L.J. 1261, 1265 (1980) ("Bargained-for promises support value-enhancing exchanges."); Morton J. Horwitz, *The Historical Foundations of Modern Contract Law*, 87 Harv. L. Rev. 917, 947 (1974) ("The role of contract law [is] simply to enforce … transactions that parties to a contract believed to be to their mutual advantage."); Daniel Markovits, *Making and Keeping Contracts*, 92

Va. L. Rev. 1325, 1332-33 (2006) (economic theory views contracts as "allow[ing] persons to coordinate their conduct to their joint advantage"); Susan Randall, *Freedom of Contract in Insurance*, 14 Conn. Ins. L.J. 107, 122 (2007-2008) (the "principle of freedom of contract" rests, in part, on the view that "individual choice furthers an efficient market, maximizing individual and social utility"); *see also* Richard J. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 Harv. L. Rev. 345, 356 (1983) ("Long-term contracts allow parties to bargain for the socially optimum mix of price and supply security.").

The efficiency benefits of contract are especially obvious in the wholesale electric industry, where buyers and sellers are "sophisticated businesses enjoying presumptively equal bargaining power." *Verizon*, 535 U.S. at 479. Sophisticated participants in the wholesale energy markets make the decision to contract based on their best projections of future market conditions. In making these projections, they rely on a wide array of information, including the projected growth of demand over time, the amount of new supply that is under development, and the anticipated price of fuel and emissions credits. Because much of this information is publicly available, economic theory recognizes that neither the buyer nor the seller will be able to realize substantial advantages over one another or, indeed, over the market as a whole. *See, e.g.*, Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J.L. Econ. & Org. 230, 244 (1993) ("[T]he legal system can do no better than to

grant complete freedom of contract" to parties that are "symmetrically informed at the time that they reach the initial agreement."); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 Yale L.J. 541, 554 n.24 (2003) (even the existence of asymmetric information will result in contracts that "are efficient given the information structure facing the parties" and "the state seldom can improve on constrained efficient contracts because information that was unavailable to the parties is unlikely to be available to the decisionmaker"); *cf. Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988) (recognizing that "most publicly available information is reflected in market price").

Moreover, sophisticated buyers and sellers bargaining at arm's length have the incentive and ability to strike a deal that is congruent with the interests of the consuming public. Long-term wholesale power contracts ensure that retail customers, as well as buyers themselves, will be able to obtain reliable supplies at predictable and controlled rates. In negotiating their contracts, wholesale buyers will seek out the lowest rates because they may be prohibited by state regulators from passing-through to their retail customers costs that were not prudently incurred.[7] Conversely, sellers will refrain from

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[7] In setting retail rates, state commissions cannot question the reasonableness of rates approved by FERC, but they do retain their authority to disapprove the pass-through of purchasing costs that were not prudent. *See, e.g.*, *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 972 (1986) ("[W]e may assume that a particular *quantity* of power procured by a utility from a particular source could be deemed unreasonably excessive if lower cost power is available elsewhere, even though

attempting to charge exorbitant rates because they know that they must compete with other producers to make sales and that anticompetitive conduct is subject to regulatory and antitrust oversight. Furthermore, with the advent of market-based pricing, *see Morgan Stanley*, 128 S. Ct. at 2740-42, sellers have no guarantee of cost recovery and must instead rely on their competitive sales to generate profits. Accordingly, parties in the wholesale energy markets

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the higher cost power actually purchased is obtained at a FERC-approved, and therefore reasonable, *price*."); *Miss. Power & Light Co. v. Mississippi*, 487 U.S. 354, 373-74 (1988) ("[I]t might well be unreasonable for a utility to purchase unnecessary quantities of high-cost power, even at FERC-approved rates, if it had the legal right to refuse to buy that power."); *Ky. W. Va. Gas Co. v. Pa. PUC*, 837 F.2d 600, 609 (3d Cir.) ("[A] state cannot independently pass upon the reasonableness of a wholesale rate on file with FERC" but "a state commission may legitimately inquire into whether the retailer prudently chose to pay the FERC-approved wholesale rate of one source, as opposed to the lower rate of another source."), *cert. denied*, 488 U.S. 941 (1988); *Commonwealth Elec. Co. v. Dep't of Pub. Utils.*, 491 N.E.2d 1035, 1045 (Mass. 1986) ("[W]hile the [Department of Public Utilities] cannot inquire into the reasonableness of wholesale rates fixed by FERC, the DPU may inquire whether a purchaser … is warranted in agreeing to purchase at such a rate considering its alternatives.") (citation omitted), *cert. denied*, 481 U.S. 1036 (1987); *Pike County Light & Power Co. v. Pa. PUC*, 465 A.2d 735, 738 (Pa. Commw. Ct. 1983) (FERC focuses on "whether it is just and reasonable for [a seller] *to charge* a particular rate, but makes no determination of whether it is just and reasonable for [the buyer] *to incur* such a rate as an expense"). Prudence reviews by state commissions provide an additional level of protection to retail customers by ensuring that buyers have struck a reasonable bargain at the time of contracting. This approach is consistent with the principles underlying *Mobile-Sierra*: regulators are not permitted to undermine the integrity of contracts, but may require buyers to bear fully the costs of their "improvident bargains." *Sierra*, 350 U.S. at 355.

should be expected to reach allocations of risk and reward that, over the long haul, are economically efficient as to third parties, and to do so without incurring the enormous transaction costs associated with a bargaining process that included all third parties that may ultimately be affected by a contract.

In light of these principles, this Court rightly recognized in *Morgan Stanley* that a negotiated contract rate is presumptively "just and reasonable" not only as to the contracting parties but also as to the Commission, the quintessential third party charged by Congress with the protection of the public interest. *See* 128 S. Ct. at 2746 ("*Sierra* … provided a definition of what it means for a rate to satisfy the just-and-reasonable standard in the contract context."). The *Mobile-Sierra* presumption of justness and reasonableness is, indeed, fundamentally a limitation on the Commission's own authority to upset voluntary contractual bargains. *Id.* ("[O]nly when the mutually agreed-upon contract rate seriously harms the consuming public may the Commission declare it not to be just and reasonable.").

Because the *Mobile-Sierra* presumption is premised on the agreement of willing and sophisticated parties, the Commission retains "ample authority to set aside a contract where there is unfair dealing at the contract formation stage—for instance, if it finds traditional grounds for the abrogation of the contract such as fraud or duress" or if "'dysfunctional' market conditions under which the contract were formed" were the directly caused result of illegal market manipulation by one of the contracting parties. *Id.* at 2747. For the same reason, the *Mobile-Sierra* doctrine would not be

interpreted to permit one party to "thrust" unilaterally upon others terms to which they "have vociferously objected." Pet. App. 22a.[8]

The *Mobile-Sierra* doctrine also provides the Commission ample tools to protect the interests of non-contracting third parties where there has been no unfair dealing at the contract formation stage. Indeed, the "sole concern" of the Commission when faced with a valid, voluntarily negotiated contract is the protection of the public interest. *Morgan Stanley*, 128 S. Ct. at 2746 n.3 (citing *Sierra*, 350 U.S. at 355). But the governmental power to undo otherwise valid contracts in the public interest must be exercised with great restraint. As this Court has long recognized, private contracts will always "in some respect, however slight, affect the public," *Nebbia v. New York*, 291 U.S. 502, 524-25 (1934), but even in the case of "businesses affected with a public interest" regulation must reflect a "reasonable exertion of governmental authority." *Id.* at 536; *see also Chas. Wolff Packing Co. v. Court of Indus. Relations*, 262 U.S. 522, 536 (1923) ("[T]he mere declaration … that a business is affected with a public interest is not conclusive of the question whether … attempted regulation on that ground is justified."). To preserve the long-term benefits that

[8] Despite its stated concern about such cram-downs, the D.C. Circuit made no attempt to tailor its holding to situations where there is no contractual agreement whatsoever, or, as with the contested settlement agreement in the case below (*see* Pet. App. 5a), where agreement is only reached by a subset of the negotiating parties. Instead, the court of appeals categorically held that the *Mobile-Sierra* doctrine is simply inapplicable where *any* non-contracting third party seeks to challenge the terms of an existing contract. Pet. App. 22a.

contracts provide to market participants and the industry as a whole, "the FPA intended to reserve the Commission's contract-abrogation power for those *extraordinary* circumstances where the public will be *severely* harmed." *Morgan Stanley*, 128 S. Ct. at 2749 (emphasis added).

In this case, the D.C. Circuit went far beyond what is necessary to ensure the "existence of a voluntary contract between the parties," Pet. App. 21a, to protect the integrity of the contracting process, or to protect the public from extraordinary harm: Even where there is a valid bilateral or multilateral agreement, it held that the *Mobile-Sierra* doctrine "simply does not apply" if the agreement is later challenged by any third party. Pet. App. 22a. In the D.C. Circuit's view, the *Mobile-Sierra* public interest standard does not adequately protect the public. Ignoring the fact that "contract stability ultimately benefits consumers," *Morgan Stanley*, 128 S. Ct. at 2749, the court of appeals held that third parties should be completely exempted from the restrictions of the *Mobile-Sierra* doctrine because they need the ability "successfully [to] challenge rates in cases of changed circumstances." Pet. App. 23a.

The D.C. Circuit's approach gives "short shrift to the important role of contracts in the FPA." *Morgan Stanley*, 128 S. Ct. at 2749. Although there will always be a "winner" and a "loser" given the difficulty in perfectly predicting future market conditions, this does not justify relieving sophisticated buyers and sellers—or third parties indirectly affected by their bargain—of the consequences of informed and voluntary contracting decisions. Contracts are a necessary and

valuable risk-management tool precisely because parties understand that their market projections may later prove inaccurate and therefore seek efficiently to allocate the risk of "changed circumstances" among themselves. Thus, "a fixed-price contract is an explicit assignment of the risk of market price increases to the seller and the risk of market price decreases to the buyer." *N. Ind. Pub. Serv. Co. v. Carbon County Coal Co.*, 799 F.2d 265, 278 (7th Cir. 1986); *see also* Posner, *supra*, at 119 (because "an important function of contracts is to assign risks to superior risk bearers," the party assigned the risk "must pay" when "the risk materializes"). Because contracting parties have allocated the risk of price fluctuations between themselves and will organize their affairs in reliance on their contractual bargains, economists have long recognized that it would be counterproductive and injurious to consumer welfare to invite contract modification whenever market prices do not turn out as expected.[9] Contrary to the D.C. Circuit's

[9] *See, e.g.*, Schwartz & Scott, *supra*, 113 Yale L.J. at 565 ("[W]ithout legal enforcement, private contracting parties cannot be expected often to create deals that maximize social surplus."); Goetz & Scott, *supra*, 89 Yale L.J. at 1270 (where contract performance is uncertain, a party will limit its behavior adjustments, thereby giving up "the value of the prospective beneficial reliance that would accrue from full adaptation to the advance knowledge of a promissory performance"); *id.* at 1274 ("Precautionary adjustments by the promisor decrease the value of the promise."); Daniel A. Farber, *Contract Law and Modern Economic Theory*, 78 Nw. U. L. Rev. 303, 315-18 (1983); *cf.* Posner, *supra*, at 93 (the goal of efficiency is furthered by "enforcing the parties' agreement" even if it later "appears to be inefficient"). The courts have similarly emphasized that it is not the role of the government to relieve contracting parties of "hard bargains" resulting from their "indiscretions and bad judgments" as such governmental intrusion into contractual relations would

understanding, *Mobile-Sierra* limits FERC's ability to modify contracts not as an accommodation to the parties but for the benefit of the public as a whole.

## III. THE D.C. CIRCUIT'S BROAD THIRD-PARTY EXCEPTION WOULD DESTROY THE CONTRACTUAL CERTAINTY NECESSARY FOR THE EFFICIENT FUNCTIONING AND DEVELOPMENT OF THE ELECTRICAL POWER INDUSTRY

Because virtually every wholesale energy contract affects a vast number of downstream third parties, a presumption of justness and reasonableness that applied only to the contracting parties themselves would be "no presumption of validity at all, but a reinstitution of cost-based rather than contract-based regulation." *Morgan Stanley*, 128 S. Ct. at 2748. If upheld, the D.C. Circuit's third-party exception to the *Mobile-Sierra* presumption will undermine the faith in contractual certainty that lies at the heart of the doctrine and enables the efficient allocation of risk necessary to the effective operation and development of the energy industry.

Parties entering into contracts rely on the understanding that, under traditional contract law

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"create an insecurity in business transactions which would be intolerable." *Wilmington & Weldon R.R. Co. v. King*, 91 U.S. (1 Otto) 3, 5 (1875); *see also Ark. Natural Gas Co. v. Ark. R.R. Comm'n*, 261 U.S. 379, 383 (1923) ("[I]t is not an independent legislative function to vary or set aside … contracts, however unwise and unprofitable they may be."); *N. Ind. Pub. Serv. Co.*, 799 F.2d at 278 ("If … the buyer forecasts the market incorrectly and therefore finds himself locked into a disadvantageous contract, he has only himself to blame ….").

principles, their rights and obligations are defined by the terms of their contracts, safe from third party interference. *See, e.g.*, *Williams v. Eggleston*, 170 U.S. 304, 309 (1898) ("The parties to a contract are the ones to complain of a breach, and … a third party has no right to insist that it has been broken."); *United Steelworkers of Am. v. Rawson*, 495 U.S. 362, 375 (1990) ("[T]hird-party beneficiaries generally have no greater rights in a contract than does the promisee.").

Parties contracting in the wholesale energy markets have long relied on the same expectation. Indeed, the *Mobile-Sierra* doctrine acts principally as a limitation on interference by the Commission—the ultimate third-party enforcer charged by Congress with oversight of wholesale rates for the public benefit. The Commission is "*required* … to apply the *Mobile-Sierra* presumption in its evaluation" of fixed-price, long-term contracts, regardless of when it is asked to undertake such a review. *Morgan Stanley*, 128 S. Ct. at 2745. This limitation appropriately bars FERC (itself a third party) from applying a hindsight notion of what would have been a "reasonable" contract rate, and instead ensures that the voluntary bargains struck by the parties at the time of contracting are respected. The D.C. Circuit's holding, however, would provide any other third party the unbounded ability to demand review of contract rates free of the presumption of reasonableness.

The D.C. Circuit's third-party exception would invite frequent and wholesale *ex post* regulatory interference with voluntarily negotiated contracts. The D.C. Circuit made no effort to confine its holding to the situation before it. Under the court of appeals'

holding, even when parties have voluntarily assented to the terms of a contract, their agreement is not safe from third party challenge, regardless of whether the challenger participated in contract negotiations but refused to agree, or is only indirectly affected by the contract. But the FPA governs "the business of transmitting and selling electric energy for ultimate distribution to the public." 16 U.S.C. § 824(a). Every wholesale contract reviewed by the Commission affects retail customers down the line, and there will accordingly *always* be some customer or consumer advocate with an interest in relieving a buyer of a contract rate that, in hindsight, appears too high. A seller competing for a buyer's business will also have an incentive to exploit the third-party exception and break existing contractual obligations so that the buyer is free to seek alternative sources of supply. And the FPA's liberal standing rules would give all of them the right to launch such *ex post* challenges. *See* discussion of standing in Brief of the Electric Power Supply Association, *et al.* as *Amici Curiae* in Support of the Petition for Certiorari at 8-9, No. 08-674 (filed Dec. 22, 2008) ("EPSA Brief").

State regulators and consumer advocates have already demonstrated their zeal to challenge in hindsight the reasonableness of contract rates agreed to by sophisticated buyers and sellers. For example, in a companion case to *Morgan Stanley*, two California state agencies purporting to act in the interest of the State's retail customers filed complaints with FERC seeking to lower the long-term contract rates agreed to by their sister agency, the California Department of Water Resources, when contracting for the benefit of those same retail customers. *See Pub. Utils. Comm'n*

*of Cal. v. Sellers of Long Term Contracts to the Cal. Dep't of Water Res.*, 103 F.E.R.C. ¶ 61,354, *order on reh'g*, 105 F.E.R.C. ¶ 61,182 (2003), *remanded sub nom. Pub. Utils. Comm'n of Cal. v. FERC*, 474 F.3d 587 (9th Cir. 2006), *vacated and remanded sub nom. Sempra Generation v. Pub. Utils. Comm'n of Cal.*, 128 S. Ct. 2993 (2008), *and vacated and remanded*, *Pub. Utils. Comm'n of Cal. v. FERC*, 550 F.3d 767 (9th Cir. 2008). Although this Court vacated and remanded the Ninth Circuit's decision in their favor in light of *Morgan Stanley*, those state agencies are currently arguing before the Commission that their challenge should not be governed by *Morgan Stanley*, or *Mobile-Sierra* principles generally, because—since a different California agency was the signatory to the contracts—the two challengers are "third parties." *See* Answer and Cross-Motion of the Public Utilities Commission of the State of California for an Order Governing Procedures on Remand, FERC Docket Nos. EL02-60-003 *et al.*, at 22-26 (filed Jan. 14, 2009); Answer of the Public Utilities Commission of the State of California to Cross Motion of Sempra Generation and Cross Motion for Summary Disposition, FERC Docket Nos. EL02-60-003 *et al.* (filed Jan. 21, 2009); Motion for Leave to Answer of the Public Utilities Commission of the State of California and Answer of the Public Utilities Commission of the State of California to Answer of Indicated Sellers and Answer of Sempra Generation, FERC Docket Nos. EL02-60-003 *et al.* (filed Feb. 9, 2009). The Illinois Attorney General also filed a complaint with FERC seeking to abrogate wholesale contracts awarded to sellers submitting the lowest bids in a descending clock auction supervised by state utility regulators and economic experts. *See* Amended Complaint by the People of the State of

Illinois *ex rel.* Illinois Attorney General Lisa Madigan, FERC Docket No. EL07-47-000 (filed Mar. 16, 2007); *see also* Section 206 Complaint, FERC Docket No. EL07-50-000 (filed Mar. 26, 2007) (complaint by California consumer group challenging contract). Such challenges will only become more common if petitions by downstream consumers and their representatives are not subject to the strictures of the *Mobile-Sierra* doctrine.

If the D.C. Circuit is upheld, parties seeking to allocate risk between themselves through contract will routinely be forced to attempt to negotiate terms and conditions that account for potential contract challenges by non-contracting third parties who are not present at the negotiating table. This would greatly complicate contractual bargaining, vastly increase transaction costs, and despite the parties' best efforts, expose their bargains to potentially endless litigation by a wide array of third parties.

These developments would be all the more harmful because their effects would almost surely prove asymmetrical. In theory, the D.C. Circuit's third-party exception would allow parties with an interest in a seller's financial health (*e.g.*, the seller's shareholders, lenders and suppliers) to bring contract challenges against rates that in hindsight appear too low. As a practical matter, however, some may argue that such entities are not true third parties with independent standing. Any third-party exception is therefore very likely to be a one-way ratchet, allowing buyers, but not sellers, to be relieved of contractual bargains that later prove unprofitable. *But see Morgan Stanley*, 128 S. Ct. at 2747 ("The standard for a buyer's challenge must be

the same, generally speaking, as the standard for a seller's challenge: The contract rate must seriously harm the public interest.").

At a minimum, sellers faced with the threat of asymmetrical contract modification will demand a substantial premium to compensate for the risk that consumers or their proxies will later challenge contract rates as being too high. *See, e.g.*, *Standard of Review for Proposed Changes to Market-Based Rate Contracts for Wholesale Sales of Elec. Energy by Pub. Utils.*, 100 F.E.R.C. ¶ 61,145, at 61,545 (2002) ("Investors will not participate in a market in which disgruntled buyers are allowed to break their contracts, at least not without charging a significant risk premium.") (Brownell and Breathitt, Commissioners, concurring); *see also Puget Sound Energy, Inc. v. All Jurisdictional Sellers of Energy and/or Capacity at Wholesale into Elec. Energy and/or Capacity Markets in the Pac. Northwest*, 103 F.E.R.C. ¶ 61,348, at 62,368-69 (2003) (threat of refunds "would cause a loss of confidence in the market, have a chilling effect on trading, cause costs to customers to increase as market participants demand additional risk premiums and additional security for their transactions, create a hesitancy to conduct business in times of scarcity, and discourage investment in needed infrastructure"); *Cal. Indep. Sys. Operator Corp.*, 108 F.E.R.C. ¶ 61,254, at 62,409-10 (2004) (explaining that a methodology that "reduc[es] cost uncertainty and the corresponding need for a risk premium" reduces costs to consumers).[10] At worst,

[10] In the underlying proceedings before the Commission, various parties explained that the *Mobile-Sierra* provision in the contested settlement agreement was intended to "reduce regulatory uncertainty and the risk premium that may be

because the very purpose of long-term contracts is to allow parties to hedge the risk of market fluctuations, an asymmetrical standard that encourages third party retail customers or their representatives to challenge contracts deemed to be "out-of-the-money" after the fact could cause sellers to abandon the market for long-term contracts altogether. *See, e.g.*, Posner, *supra*, at 8 ("If a party for whom a contract to which he freely agreed turns out badly is allowed to revise the terms of the contract ex post, few contracts will be made."); Kronman & Posner, *supra*, at 4 (same). Both results would be economically inefficient and would harm consumers over the long-run: consumers will be either asked to bear costly risk premiums, or the market will be deprived of rate-stabilizing contracts necessary for investment in infrastructure.

Far from the beneficial safety net imagined by the D.C. Circuit, a third-party exception would ultimately harm the public. It would arm third parties who have not sunk their own capital into investments with the right to interfere with mutually agreed-upon contracts. Such parties' private incentives would generally be to seek contract modification or abrogation so as to secure better terms for themselves on the backs of others' sunk investments. A multiplication of these challenges would weaken the ability of wholesale buyers and sellers to rely on long-term contracts and hinder needed investments, imposing external costs across the

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required by new entrants." Pet. App. 196a. The Commission agreed that "[s]tability is particularly important in this case, which was initiated in part because of the unstable nature of … revenues and the effect that has on generating units." Pet. App. 202a.

entire public. This is the antithesis of an efficient marketplace.

These threats are not merely theoretical or abstract. Because electric generation "project funding [in today's competitive markets] is based on anticipated market-based projections of costs, revenues and relevant risk factors," Electric Energy Market Competition Task Force, *Report to Congress on Competition in the Wholesale & Retail Markets for Electric Energy Pursuant to Section 1815 of the Energy Policy Act of 2005* 78 (Apr. 2007),[11] long-term contracts are "critical in obtaining financing for new generation and ensuring adequate supplies for retail loads at predictable prices." *Id.* at 4. Indeed, FERC has recognized that "[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." *Pub. Utils. Comm'n of Cal. v. Sellers of Long Term Contracts to the Cal. Dep't of Water Res.*, 99 F.E.R.C. ¶ 61,087, at 61,383 (2002). At the same time, and as explained in the EPSA Brief, approximately $400 billion in electric infrastructure investment is required over the next 15 years. EPSA Brief at 10-11 (citations omitted). By lowering the bar for third-party challenges to voluntarily-struck bargains, the D.C. Circuit's broad third-party *Mobile-Sierra* exception would erode contract certainty and deter parties from entering into the contracts necessary for rate stability and infrastructure

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[11] *Available at* http://www.ferc.gov/legal/fed-sta/ene-pol-act/epact-final-rpt.pdf.

investment precisely at the time when they are most needed.

## CONCLUSION

For the foregoing reasons, the D.C. Circuit's decision should be reversed.

Respectfully submitted,

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# APPENDIX

# APPENDIX
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