U.S. Supreme Court Preserves *Mobile-Sierra* Doctrine

June 30, 2008

On June 26, 2008, in *Morgan Stanley Capital Group Inc. v. Public Utility District No. 1 of Snohomish County* (No. 06-1457), the U.S. Supreme Court revisited and clarified the 50-year-old *Mobile-Sierra* contract-finality doctrine in the context of fixed-rate, forward power contracts in the wholesale electric markets regulated by the Federal Energy Regulatory Commission (FERC). At issue was whether and under what circumstances FERC could modify the rates in such contracts on the grounds that there was a dysfunctional market place at the time the contracts were executed. The Court's decision, by assuring continued application of the *Mobile-Sierra* doctrine even in cases where it is alleged that the markets were dysfunctional, should provide contracting parties with confidence that their bargains will be upheld except in the most extreme circumstances. This should have a positive effect on the industry, allowing parties to enter into long-term contracts without the concerns they may have had before this ruling.

The premise of the *Mobile-Sierra* doctrine is that the Federal Power Act (FPA) and the Natural Gas Act presume the justness and reasonableness of rates negotiated by private parties at arm's length and do not sanction FERC's modification of such rates unless the terms of the contract threaten the "public interest" or the contract expressly allows for it. The so-called "public interest standard" is generally considered to be a difficult threshold to meet and therefore contracts subject to the standard cannot usually be modified.

The decision by the Ninth Circuit below was one of several issued by that court that suggested that FERC had been misapplying the principles of *Mobile-Sierra* to transactions that occurred in California and other western states during prices spikes in 2000–2001. The underlying issue was whether the circumstances in the markets at that time now justify FERC exercising authority under the FPA to modify long-term contracts after the crisis has passed and prices have fallen. Such action is viewed as potentially eroding the "sanctity of contract" concept for fixed-rate contracts, at least those contracts executed at comparatively high prices during times of significant market volatility or dysfunction. In the decision below, the Ninth Circuit noted the FPA's requirement that rates be "just and reasonable" and held that the *Mobile-Sierra* doctrine precluded FERC's interference with the bargain of the parties only when FERC had an opportunity for "effective, timely review of the contracted rates," including review of whether the contract was executed in the context of a "functional marketplace." The Ninth Circuit also held that the standard for overcoming the *Mobile-Sierra* presumption was a different, lesser burden than if the party challenging the rate was the purchaser, rather than the seller.

In overturning the Ninth Circuit's interpretation of *Mobile-Sierra*, but upholding the

remand of the case to FERC, the Supreme Court, in an opinion authored by Justice Scalia, observed that there is but one standard in the FPA under which a rate is to be judged, *i.e.*, whether the rate is "just and reasonable." However, it clarified that, in the context of negotiated contracts, the "public interest standard" of *Mobile-Sierra* is merely a differing application of the "just and reasonable" standard to contract rates. Under the *Mobile-Sierra* presumption, a mutually agreed upon contract rate is just and reasonable unless the rate is found to "seriously" harm the public interest. Disagreeing with the Ninth Circuit, the Court held that a determination of whether a rate seriously harms the public interest is not to be restricted to the time at which the contract is formed, but is applicable during the life of the contract. The Court rejected the interpretation of *Mobile-Sierra* that a finding of reasonableness at the execution of a contract inoculates the rate for the life of the contract.

The Court also rejected the Ninth Circuit's ruling that FERC must inquire into whether a contract was formed in a well-functioning market before applying the *Mobile-Sierra* presumption. The Court recognized that markets are not perfect and are sometimes volatile. Indeed, it is often such volatility that leads market participants to enter into long-term agreements. The Court observed that allowing contracts to be undone after the volatility had dissipated would remove the incentive for market participants to enter into forward contracts in the first instance. The Court's opinion stated that "the mere fact that the market is imperfect, or even chaotic, is no reason to undermine the stabilizing force of contracts that the FPA embraced as an alternative to 'purely tariff-based regulation.'"

The Court also rejected the Ninth Circuit's holding that, in the context of a purchaser's challenge to a contract rate on the grounds that it is too high, the appropriate test is whether the rate falls within a "zone of reasonableness." The Ninth Circuit held that a rate fell outside the zone if the "consumers' electricity bills are higher than they would otherwise have been had the challenged contracts called for rates within the just and reasonable range, *i.e.*, rates that equal marginal cost." In rejecting a marginal cost approach to determining whether rates are just and reasonable, the Court observed that such an approach would threatened to inject even more volatility into the market and that 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—which is why it permits rates to be set by contract and not just by tariff."

Interestingly, on two occasions, the Court specifically stated that it was not ruling on the lawfulness of FERC's underlying market-based rate regime, leaving open the possibility of future challenges.

The Court concluded, however, that remand to FERC was appropriate because FERC's decision was lacking on two points. First, the Court was unable to determine if FERC restricted its review of the rates to the time immediately following execution of the contract. The Court reiterated that the appropriate test was whether the challenged rates constituted an excessive burden on consumers "down the line"

relative to the rates that could have been obtained after elimination of the dysfunctional market. It clarified that while a comparison of the challenged rate to rates immediately prior to execution was relevant, FERC must also compare them to rates that would have obtained in a non-dysfunctional market. Again, the analysis is not restricted to the time the contract is formed.

Second, some of the purchasers in the underlying case alleged that certain sellers manipulated the spot markets in California, which negatively affected forward market prices under review. In addition, FERC staff had issued a report concluding that abnormally high prices in the spot market affected terms of contracts in the forward markets. The Court held that, like in cases of fraud, if a party to a challenged contract engaged in "such extensive market manipulation" as to alter the playing field for contract negotiations, the *Mobile-Sierra* presumption should not apply. Clarifying, the Court referred to such manipulation as having to "directly affect[]" contract negotiations: "[w]e emphasize that the mere fact of party's engaging in unlawful activity in the spot market does not deprive its forward contracts of the benefits of the Mobile-Sierra presumption." Thus, the Court held that causality must be established between the market behavior of the party and the rate under review before the *Mobile-Sierra* presumption was inapplicable.

The Court's decision, by assuring continued application of the *Mobile-Sierra* doctrine even in cases in which it is alleged that the markets were dysfunctional, should provide contracting parties with confidence that their bargains will be upheld except in the most extenuating of circumstances. In order for contract rates to be undone, the rate must seriously burden the public interest or must have been directly affected by the market manipulation of one of the contracting parties. This is an important clarification for market participants located in areas of the country where long-term contracts play a significant role.

On remand, the purchasers will have to make a showing that one or both of the above situations applied in these cases. However, it is worth noting that in her initial decision the Administrative Law Judge determined that even when applying the usual "just and reasonable standard" to the evidence offered at the trial, the proponents failed to meet the normal burden with the evidence provided. FERC's original and rehearing orders affirming the results of the Administrative Law Judge's initial decision did not address this basis that she employed as an alternative to *Mobile-Sierra* for rejecting the high rate challenges. If FERC applies this alternative standard on remand, it could obviate the need for another prolonged round of evidentiary hearings.

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