

Supreme Court Clarifies the Mobile-Sierra Doctrine's Public Interest Standard

The Supreme Court has clarified the *Mobile-Sierra* doctrine's public interest standard in cases involving negotiated contracts challenged under the "just and reasonable" standards of sections 205 and 206 of the Federal Power Act ("FPA"). *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1*, No. 06-1457 (June 26, 2008). The Court ruled that the doctrine, derived from two 1956 Supreme Court cases involving rate provisions of the FPA and the Natural Gas Act ("NGA"), presumes that rates in freely negotiated contracts for the sale of electricity or natural gas at wholesale are just and reasonable. Such rates may not be reformed by the Federal Energy Regulatory Commission ("FERC") unless this presumption is rebutted by a showing that the contracted rates impair the public interest. The *Morgan Stanley* decision provides important clarification of the doctrine, and guidance on its application to all negotiated contracts.

THE MOBILE-SIERRA DOCTRINE

The *Mobile-Sierra* doctrine stems from *United Gas Pipe Line Co. v. Mobile Gas Services Corp.*, 350 U.S. 332 (1956) ("*Mobile*") and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) ("*Sierra*"). Those cases rejected attempts by regulated utilities to use the NGA and the FPA to obtain higher rates than provided in their negotiated contracts. The cases recognize that energy buyers and sellers that freely enter contracts are sophisticated businesses attuned to managing risk through rate negotiations. To be deemed unlawful, therefore, a contract rate must be inconsistent with the public interest, that is, it must: "impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Sierra* at 354-355. Over the past half century, FERC and the lower courts have extended the *Mobile-Sierra* analysis to post-contract rate changes sought by both sellers and buyers, and have distinguished between the statutory just and reasonable standard and the public interest considerations identified in the original *Mobile-Sierra* cases.

THE MORGAN STANLEY LITIGATION

FERC's decisions and the Ninth Circuit's Rulings

This case came before the Supreme Court on review of decisions of the Ninth Circuit that set aside FERC orders refusing to reform rates in long-term wholesale power purchase contracts. The contracts had been negotiated during the Western Energy Crisis of 2000-2001 under market-based rate ("MBR") tariffs that were filed by the sellers and approved by FERC.

On complaints by the buyers that the contract rates were unreasonably high, FERC ruled that the *Mobile-Sierra* decisions required it to review the contracts under the public interest standard, as distinct from the statutory just and reasonable standard, and that the complaining buyers had failed to prove that the contract rates impaired the public interest. FERC therefore refused to modify the contract rates.

The Ninth Circuit’s judgment set aside and remanded the Commission’s decisions as arbitrary and capricious, and inconsistent with the FPA. The court held that the *Mobile-Sierra* doctrine does not apply to specific contracts unless the Commission has an opportunity to review them before they become effective, an opportunity not typically available for power sales agreements negotiated under MBR tariffs. The Ninth Circuit also held that the *Mobile-Sierra* doctrine does not apply to contracts negotiated during a period of market dysfunction like the 2000–2001 energy crisis in the West. In the alternative, the court of appeals ruled that, assuming *Mobile-Sierra* applies, the public interest standard for evaluating *buyer* complaints that negotiated rates are too high is different from the standard for public utility *sellers* claiming that such rates are too low. It ruled that a buyer-challenged rate imposes an “excessive burden on consumers” (one of *Mobile-Sierra*’s public interest factors) if the agreed rate falls outside of a “zone of reasonableness” determined by the public utility seller’s marginal costs.

THE SUPREME COURT’S DECISION

Because Chief Justice Roberts and Justice Breyer were recused, the case was decided by a seven-Justice quorum. The Court rejected the Ninth Circuit’s analysis, but nevertheless affirmed its judgment on alternative grounds. The case was remanded for reconsideration of the contracts by FERC under the correct standard. Justice Scalia’s opinion for the majority was joined by Justices Kennedy, Thomas, and Alito. Justice Ginsberg concurred in the judgment and in the majority’s alternative grounds. Justices Stevens and Souter vigorously dissented.

The Majority Opinion

At the outset, the Court held that the public interest test in its *Mobile-Sierra* decisions is not distinct from the statutory just and reasonable test. Rather it is a presumption to be applied by FERC in evaluating the justness and reasonableness of rates established by contract.

The Court categorically rejected the the Ninth Circuit’s holding that the *Mobile-Sierra* presumption applies only where there has been an opportunity for FERC to review the agreed rates before the contract goes into effect. The Court also rejected the Ninth Circuit’s ruling that the *Mobile-Sierra* presumption does not apply to contracts formed in an atmosphere of “market dysfunction.” It explained that “one of the reasons that parties enter into wholesale-power contracts is precisely to hedge against the volatility that market imperfections produce.” If sophisticated parties who weather market turmoil by entering long-term contracts can renounce their contracts when stability returns and prices drop, the incentive for sellers to enter such such contracts in the future would be reduced.

Also set aside was the Ninth Circuit’s alternative holding that challenges by buyers under MBR contracts satisfy the “excessive burden” element of the public interest if the rates exceed the seller’s marginal cost. The Supreme Court held that “[a]presumption of validity that disappears when the rate is above marginal cost is no presumption of validity at all, but a reinstatement of cost-based rather than contract-based regulation.” Thus, “[t]he Ninth Circuit’s standard would give short shrift to the important role of contracts in the FPA, and would threaten to inject more volatility into the electricity market by undermining a key source of stability.” (The majority expressly

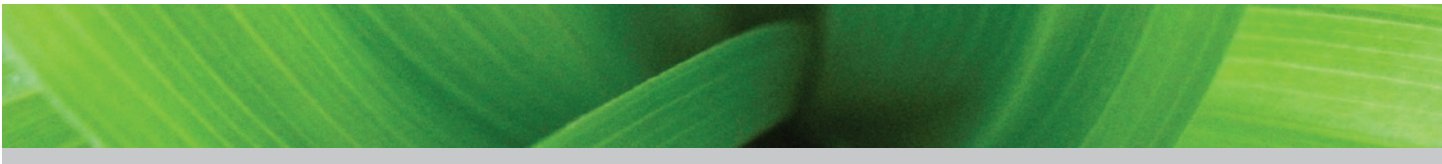
declined, however, to address the lawfulness of the market-based rate regime itself because that issue was not presented in this case.)

Although the Court rejected the Ninth Circuit’s reasoning, it affirmed the Ninth Circuit’s judgment on alternative grounds. First, it ruled that FERC, in finding no “excessive burden on consumers” under *Mobile-Sierra*’s public interest test, had construed the “burden” element too narrowly. The Commission had assessed that burden by examining only the disparity between the rates consumers were paying before the wholesale contract became effective and the rates they paid immediately after. While the Court deemed that disparity to be relevant, it ruled that FERC should also have considered “the disparity between the contract rate and the rates consumers would have paid (but for the contracts) further down the line, when the open market is no longer dysfunctional.... The ‘unequivocal public necessity’ that justifies overriding the *Mobile-Sierra* presumption does not disappear as a factor once the contract enters into force.” Therefore, FERC must consider the burden on consumers over the term of the contract, not just the burden at the contract’s outset.

Second, the Court held that FERC had failed to evaluate whether parties to the contracts had skewed the playing field for rate negotiations by unlawfully manipulating the California spot markets before or at the time the contracts were made. “Like fraud and duress, unlawful market activity that directly affects contract negotiations eliminates the premise on which the *Mobile-Sierra* presumption rests: that the contract rates are the product of fair, arms-length negotiations.” Even unlawful activity in different but related markets can be found to affect contract negotiations. However, “[t]he mere fact of a party’s engaging in unlawful activity in the spot market does not deprive its forward contracts of the benefit of the *Mobile-Sierra* presumption.” Such deprivation can occur only if FERC finds a causal connection between a contracting party’s misconduct and the specific contract rate. The Court’s emphasis on party-specific causality shows that the manipulation determinations must be proved seller-by-seller and contract-by-contract, and that a finding of a party’s manipulation in a related market does not automatically defeat the *Mobile-Sierra* presumption.

The Dissent

The dissenters contended that neither §§205 and 206 of the FPA nor the *Mobile-Sierra* decisions support the Court’s presumption that freely negotiated contracts are just and reasonable. They also asserted that the Court had wrongly ruled that the public interest presumption is mandatory, and that the burden of proof to rebut it is higher than the ordinary burden for showing that a contract rate is unjust and unreasonable. In any event, the dissenters argued, the presumption could not be considered on judicial review in these cases because FERC had nowhere invoked it; its rulings rested on its mistaken view that the public interest and just and reasonable standards are distinct tests. In addition, the dissenters agreed with the Ninth Circuit that FERC erroneously failed to consider “circumstances exogenous to contract negotiations, including natural disasters and market manipulation by entities not parties to the challenged contract.”



MORGAN STANLEY'S SIGNIFICANCE

The Court has now confirmed that the public interest standard established in the original *Mobile-Sierra* is not an alternative to the statutory requirement that all rates be just and reasonable, but rather a presumption implementing that requirement in the context of all contracts, whether market-based or cost-based. Such contracts can be modified by FERC only when required by a strong showing that the public interest has been impaired, absent express agreement to the contrary. This standard applies equally to buyers and sellers who seek rate changes from FERC. On the other hand, the Court has imposed on FERC a broader public interest inquiry than it previously recognized. FERC must now consider any significant consumer burdens that may arise over the life of the contract, and any manipulation by the parties of the market or related markets that is causally linked to the challenged rate.

FOR ADDITIONAL INFORMATION

Van Ness Feldman represents natural gas pipelines and electric utilities before FERC on standards of conduct policy, ratemaking, and regulatory matters. For more information about how this decision will affect your company, please contact Doug Smith, Gary Bachman, Howard Shapiro, or any member of our Electricity Practice Group or contact Paul Korman, Susan Olenchuk, or any other member of our Natural Gas Practice at (202) 298-1800.

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