

Client Alert

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Ninth Circuit Decisions Threaten Market-Based Rate Contracts

The Supreme Court's "*Mobile-Sierra* doctrine,"¹ as interpreted by the courts for decades, has long given parties with contracts subject to the Federal Energy Regulatory Commission's (FERC or Commission) jurisdiction a relatively high degree of certainty that their contracts would not be subject to modification by FERC, absent a showing that the rate would "adversely affect the public interest." As understood by the courts and FERC, this public interest test would permit the undoing of a contract only in "extraordinary circumstances" beyond mere buyer's or seller's remorse. On December 19, 2006, the United States Court of Appeals for the Ninth Circuit issued two opinions – *Public Utility District No. 1 of Snohomish County, et al. v. FERC (Snohomish)*² and *California Public Utilities Commission v. FERC (CPUC)*³ – and radically reshaped both the applicability and application of this public interest test in ways that will undermine this certainty substantially and have significant implications for suppliers of electricity, natural gas and natural gas storage services at market-based prices.

The Ninth Circuit held that the *Mobile-Sierra* public interest standard can only apply to market-based rate contracts where FERC has engaged in "effective oversight" after the initial grant of market-rate authority, to permit timely reconsideration of market-based rate authority if market conditions change.

Thus, a buyer or third party may be permitted later to challenge the propriety of market conditions at the time of contract formation in order to argue that *Mobile-Sierra* does not apply and that the rates agreed upon are not "just and reasonable."

Moreover, even where a contract meets these tests for applicability of *Mobile-Sierra*, the Ninth Circuit also departed from precedent as to how that standard should be applied in a case where a buyer or a third party challenges a rate as too high (a "high-rate" challenge). The court held that in such cases FERC should focus on whether the contract results in higher retail rates for consumers. Thus, the two decisions represent a landmark change, at least in the Ninth Circuit, of the courts' view of FERC's market-based rate program, and the degree of deference that should be accorded to FERC-jurisdictional market rate contracts when they are challenged by buyers or third parties.

Background

Section 205 of the Federal Power Act (FPA) requires rates for wholesale power sales to be "just and reasonable." In the past, when vertically integrated public utilities dominated the power markets, rates were shown to be "just and reasonable" by reference to a utility's costs. For considerably more than 10 years, however, FERC has had

"The Ninth Circuit has redefined how FERC should apply the test in the context of a "high rate" challenge."

an established program permitting a seller to make sales at market-based rates upon demonstrating that it lacks, or has adequately mitigated, market power. A seller that meets these requirements is granted blanket market-based rate authority, and is not required to file its individual market-based transaction rates with FERC. As part of this market-based rate framework, FERC also requires that market-based rate sellers comply with certain after-the-fact reporting requirements. Courts, in particular the United States Court of Appeals for the District of Columbia Circuit, have upheld FERC's discretion to rely upon market-based rates, in lieu of cost-based regulation, to assure that rates are just and reasonable.

Buyers and sellers transacting under FERC's market-based program have presumed that the *Mobile-Sierra* doctrine's stringent public interest test would mean that parties would be largely protected from post-contracting challenges seeking to modify rates unilaterally through the FERC regulatory process, as had been the case for rates in contracts justified on a cost basis. Although some case law has suggested that *Mobile-Sierra* would apply in the absence of an express provision to the contrary, contracting parties have often included a specific contractual "*Mobile-Sierra* clause" stating that it was the intent of the parties that the strict public interest test should apply if an entity later sought unilateral modification of the contract.

The *Snohomish* and *CPUC* Decisions

The Ninth Circuit decisions were the result of two separate challenges brought at FERC by load-serving utilities and agencies of the State of California seeking to abrogate or modify long-term, market-based rate contracts entered into during the Western US energy crisis of 2000-2001. In *Snohomish*, Public Utility

District No. 1 of Snohomish County, WA, Southern California Water Company and Nevada Power Company/Sierra Pacific Power Company alleged that the 2000-2001 energy crisis so distorted the short-term spot market that they were unable to negotiate reasonable long-term contracts. In *CPUC*, the California Public Utilities Commission and California Electricity Oversight Board brought similar claims against sellers that had entered into long-term contracts with the California Department of Water Resources. In each case, FERC upheld the contracts, finding that the *Mobile-Sierra* public interest test applied and that the complainants had not met their burden of justifying undoing the contracts by showing that the contracts had adversely affected the public interest. Rather, FERC found that complainants' only basis for undoing the contracts was buyer's remorse. All of the complainants appealed to the Ninth Circuit.

The Ninth Circuit disagreed with FERC's holdings and remanded to the Commission for further proceedings: (i) to determine whether *Mobile-Sierra* review of the contracts is appropriate, and (ii) to apply the "modified" form of *Mobile-Sierra* review, as defined by the Ninth Circuit. In doing so, *Snohomish* and *CPUC* present three holdings with serious consequences for sellers under FERC's market-based rate regime. First, parties cannot presume *Mobile-Sierra* will cover all market-based rate contracts; rather, it only extends to those formed in an environment where FERC could have exercised sufficient regulatory oversight to ensure that the markets were fully functional. Second, buyers and third parties can now challenge a market-based rate contract by questioning the functionality of the markets or the continued propriety of the seller's blanket market-based rate authority at the time the contract was formed. Third, even if *Mobile-Sierra* does apply to a market-based rate agreement, in a "high rate" challenge

the public interest threshold is now to be applied with much more emphasis on consumer impact, making it much easier to undo a contract based on buyer's remorse asserted by the buyer or a third party (including FERC, acting *sua sponte*). More specifically, the new tests articulated by the Ninth Circuit are as follows:

Whether the Public Interest Test Applies

To determine whether the *Mobile-Sierra* public interest test should be applied to a market-based rate contract, three preconditions must be satisfied. If they are not, FERC would be required to apply a lower legal standard ("just and reasonable") when deciding whether to undo a contract.

The contract terms must not expressly preclude application of the public interest test

- This requirement is not new. Other courts have held that parties can contract out of *Mobile-Sierra* and agree that rates can be changed through application to FERC.

The regulatory regime in which the contract is formed must provide FERC with "an opportunity for effective and timely review" of the contracted rate

- This requirement is new, and it is not entirely clear what the Ninth Circuit meant by effective and timely review. The decisions can be read to require "plenary" review by the Commission and affirmative approval of a contract as just and reasonable at the time of contract execution. Indeed, the Ninth Circuit expressly rejected FERC's view that its grant of market-based rate authority to sellers constitutes effective and timely review. This is inconsistent with FERC's current market-based rate program, which does not require the filing of contracts, but only an initial grant of blanket market-based rate authority,

quarterly reports of transactions, and triennial market updates. A potential consequence of this will be that at least some sellers will file contracts with FERC – even though they are not required to do so – and ask FERC to review and approve the contract and confirm the propriety of their market-based rate authority before their contracts go into effect.⁴

FERC's timely and effective review of market-based rates "must permit consideration of the factors relevant to the propriety of the contract's formation"

- FERC must now examine the context of the market in addition to the conduct of the parties. Also, buyers and third parties will have the opportunity to argue after-the-fact that the markets in which the contracts were negotiated and executed were somehow not fully functional.

Application of the Public Interest Test

Even if the above tests are met and the *Mobile-Sierra* public interest test is applied, the Ninth Circuit has redefined how FERC should apply the test in the context of a "high-rate" challenge. Traditionally, the courts and FERC have said that *Mobile-Sierra* would permit contract modification only in extraordinary circumstances where the rate could adversely affect the public interest, such as by impairing the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden or be unduly discriminatory. This test has not allowed a buyer or seller to undo a contract because of dissatisfaction with the bargain, and FERC's decisions in these cases were consistent with that principle. In *Snohomish* and *CPUC*, however, the court declared that the primary public interest in a high-rate challenge is whether the challenged contract imposes any significant cost

on ultimate consumers. The decisions indicate that buyers and third parties challenging a high rate need only show that the wholesale rate in the contract results in retail rates for consumers "higher than they would have been had the wholesale contract rate[] been lower." That is, buyer's remorse is a legal basis to undo a contract, though seller's remorse is not.

Impacts of the Decisions

The Ninth Circuit decisions could have significant and broad-ranging impacts. First, although the decisions addressed market-based rate power contracts, the legal implications of the Ninth Circuit's tests concerning the applicability of the *Mobile-Sierra* public interest test to the contracts at issue may extend to any FERC-jurisdictional contract that is not reviewed and "approved" by FERC, including contracts for the sale of gas and gas storage services at market-based rates. Moreover, market-based rate sellers may now need to consider, at the time a contract is formed, whether to incur upfront costs to initiate a regulatory proceeding at FERC to obtain "approval" of their contract and affirmation of the continued propriety of their market-based rate authority. Of course, such prior approval may not be feasible or realistic given that regulatory delay may not afford adequate time to prepare an application and obtain approval before a transaction is commenced.

Moreover, the legal implications of the Ninth Circuit's radical remaking of the public interest test, as applied to cases of buyer's remorse, seriously calls into question whether contracts entered into during times of tight market conditions will later be undone by FERC.⁵ Where feasible, some market participants may move increasingly to transactions that involve purely financial settlements that are arguably outside of FERC's ratemaking jurisdiction, rather than

engage in physical sales that clearly are jurisdictional.

The decisions may also have an impact on lender financing decisions, particularly if a project seeks to depend largely on a FERC-jurisdictional sale to an entity that serves ultimate retail consumers.

Market-based rate sellers or entities providing financing based directly or indirectly on revenues derived from market-based rate contracts also need to revisit what, if any, contractual language they include to try to maximize their ability to retain the *Mobile-Sierra* public interest test for any subsequent contract rate challenges. For example, sellers may wish to consider including in their contracts mutual representations and warranties or covenants acknowledging that the relevant market, at the time the transaction was formed, was functional and competitive. While such contractual provisions should be considered, the breadth of *Snohomish* and *CPUC* presents challenges to contracting parties, particularly because those decisions contemplate that buyers and third parties would have the right to argue after-the-fact that, based on new evidence, the markets in which contracts were negotiated and executed were not fully functional.

Indeed, Latham & Watkins was involved in an effort led by a working committee of the Edison Electric Institute (EEI) concerned with possible changes to the EEI Master Power Purchase & Sale Agreement and related changes to the North American Power Annex to the International Swaps and Derivatives Association (ISDA) Master Agreement (jointly developed by EEI and ISDA) to respond to the new regulatory risks posed by the *Snohomish* and *CPUC* decisions. After much discussion and consideration, the working committee decided that that these types of contractual provisions should not be included in the EEI and ISDA master agreements because they are unlikely to

protect against “high-rate” challenges brought by third parties.

Finally, the decisions in *Snohomish* and *CPUC* create additional regulatory uncertainty when coupled with the Ninth Circuit’s 2004 decision in *State of California ex rel. Lockyer v. FERC*, 383 F.3d 1006 (9th Cir. 2004) (*Lockyer*). Under the FPA, any refunds for challenged rates have generally been limited to *prospective* refunds following the filing of a complaint. In *Lockyer*, the court expanded FERC’s refund authority by permitting the possibility of retroactive refunds for all past sales where there is no meaningful review or ongoing monitoring of rates. Thus, if a complainant successfully challenges a contract mid-stream through its term (made easier by *Snohomish* and *CPUC*), refund liability could potentially extend to the beginning of the contract.

It appears likely that FERC itself will not seek *certiorari* of these decisions before the Supreme Court; however, no party has sought rehearing *en banc* of the Ninth Circuit decisions and it is now expected that one or more intervenors will file petitions for *certiorari*; petition for *certiorari* has already been filed in the *Lockyer* case. We are actively involved in and monitoring these proceedings.

Endnotes

¹ The *Mobile-Sierra* doctrine was established in *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956) (*Mobile*) and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) (*Sierra*).

² 471 F.3d 1053 (9th Cir. 2006).

³ 474 F.3d 587 (9th Cir. 2006).

⁴ In late February and early March 2007, a consumer group in California filed complaints at FERC challenging recent long-term, market-based rate power purchase agreement between an affiliate of NRG Energy, Inc. and Southern California Edison Company and long-term power purchase agreements between affiliates of Calpine Corporation and Pacific Gas & Electric Company. Relying on *Snohomish* and *CPUC*, the complaints assert that these long-term contracts must be filed with and approved by FERC.

⁵ Indeed, in March 2007, relying on *Snohomish* and *CPUC*, the Illinois Attorney General filed a FERC complaint against fifteen wholesale power suppliers asking FERC to modify the sellers’ contracts and to require refunds. The complaint asserts that FERC should apply a “relaxed” public interest standard in order to protect consumers.

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