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ELECTRICITY LAW DEVELOPMENTS – July 14, 2008

Prepared for ELCON

This report summarizes recent developments in FERC proceedings in which ELCON has been active and other matters of interest to industrial consumers. Inside this issue:

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New developments since the June 2008 issue of Electricity Law Developments are in bold. The next scheduled issue will appear in early October 2008.

I. REGULATORY PROCEEDINGS

A. ELCON Intervenes in RPM Buyers' Protest of PJM Transitional Capacity Auction Prices (Docket No. EL08-67)

On May 30, 2008, a group of state regulators, industrial customers, municipals and cooperatives calling itself the RPM Buyers filed a complaint with FERC challenging the capacity prices set in PJM Interconnection LLC's ("PJM") first four "transitional" base residual auctions under its Reliability Pricing Model ("RPM"). ELCON filed an intervention and comments in support of the protest, agreeing with RPM Buyers that serious flaws both in the structure of the PJM capacity market and in the design of the RPM mechanism will result in unjust and unreasonable capacity prices for delivery years through May 2011.

ELCON, echoing concerns raised by RPM Buyers, argued that PJM's RPM transition auctions have failed to achieve any of the stated objectives of the RPM mechanism to send proper signals regarding the value of capacity by location through the introduction of a locational element in the capacity market, encourage the entry of new and additional resources, and reduce price volatility and the potential for market manipulation. Instead, customers in PJM have experienced sudden dramatic price spikes, market mitigation was required in every zone to address the lack of competition, and the new resources that the incentive payments were supposed to attract were unable fully to participate in the auctions.

Background on PJM's RPM Mechanism

In April 2006, FERC endorsed PJM's new capacity market structure and in December 2006, conditionally approved PJM's RPM mechanism (including a settlement

reached among certain stakeholders) to establish new market rules aimed at enabling PJM to obtain sufficient capacity to reliably meet the needs of consumers within PJM at a reasonable cost.¹ PJM's then existing market rules established a single market for supply, but the structure did not assure that the supply was available to all local areas. Like previous attempts to establish a separate capacity market in parallel with PJM's energy markets, the new rules were expected to provide greater incentives for new generation, transmission, and demand response, while also providing sufficient revenues to retain existing resources that are needed for reliability. FERC also stated that it expected the overall cost to market participants to be less than what would otherwise be incurred under PJM's existing mechanisms.²

The key premise underlying the RPM mechanism was that capacity prices would be set in each area (to reflect the needs of that area) through an auction market with an administratively-determined demand curve was intended to reflect the reliability value of increased supply. The demand curve was to decrease market volatility thus creating a better market environment for investment in new generation and retention of existing plants. The program called for a three-year forward period between an auction and delivery date to increase the opportunities for competition from new generation, with a series of transitional auctions for shorter delivery periods.

¹ PJM Interconnection, L.L.C., 115 FERC ¶61,079(April 20, 2006), 117 FERC ¶61,263 (December 22, 2006).

² Among the key features of the RPM mechanism as approved were forward procurement, locational pricing phase-in in 23 locational delivery areas, and the determination of supply prices through use of a downward-sloping demand curve so that: (1) prices within each local area change gradually based on the balance between the amount of supply offered and the amount required for reliability; (2) investment would be encouraged by increased revenue stability over time; (3) the incremental value of capacity would be better indicated, thus eliminating price spikes driven by small changes in supply or reliability requirements; and (4) the potential for excessive profits through withholding or other market manipulation would be reduced or eliminated.

When FERC approved the program, it acknowledged the experimental nature of the program, noting that it was uncertain whether PJM's RPM mechanism would in fact procure the needed capacity.³ FERC stated that it would monitor performance of RPM to ensure that it was achieving its objectives and "to ensure that prices remain just and reasonable."⁴

RPM Buyers' complaint and ELCON's comments

RPM Buyers' identified numerous specific problems with the transitional auctions, including:

- Little or no new capacity was offered into the transitional auctions and there was very little capacity at prices close to RPM clearing prices.
- Supply curves were steep and inelastic at the clearing point.
- Steep and inelastic administratively-determined variable resource requirement curves were set at the wrong levels using exceptionally conservative parameters.
- Because auctions cleared on nearly vertical segments of the supply curves, withholding of small amounts of capacity resulted in a substantial increase on prices.
- Mitigation provisions, such as must-offer requirements and avoidable cost offer caps for existing generation, included exceptions that created advantageous loopholes for suppliers to justify much higher offer prices than were expected or intended when the program was designed.
- Various PJM procedures and RPM provisions excluded some capacity, further reducing supply and increasing prices.
- Locational "price signals" were highly volatile and moved as a result of regulated transmission enhancements and supplier strategic conduct. Locational Delivery Areas changed from one auction to the next and new investment was not attracted to transmission-dependent areas. Additionally, PJM imposed a stringent non-standard resource adequacy requirement that

³ 117 FERC ¶61,331 (December 22, 2006) at P. 146; 119 FERC ¶61,318 (June 25, 2007) at P. 191, 194

⁴ 119 FERC ¶61,318 at P. 194.

raised LDA reliability requirements that, coupled with the steep supply and demand curves, increased prices significantly.

In its comments, ELCON echoed many of RPM Buyers' concerns and reminded FERC that long ago ELCON had predicted the RPM model would lead to excessive prices resulting in windfalls to existing generation without notable reliability benefits. PJM touted the demand curve component of RPM as a tool to mitigate market power; however PJM's own market monitor has stated that market power in PJM's capacity market is an endemic, structural problem that is not likely soon to be resolved, and certainly will not be resolved simply with implementation of an administratively-set demand curve.

ELCON further argued that the resulting prices are unjust and unreasonable and cannot be justified on the basis of RPM's experimental nature. Courts have found that even experimental regulatory programs must result in just and reasonable rates to be upheld.

PJM's Response

PJM responded to the complaint stating while they do not object to RPM Buyers questioning assumptions underlying the RPM construct or challenging its basic elements, the challenges are "packaged ...into a complaint that invites the Commission to sweep away the results of RPM's completed auctions." PJM characterizes the complaint as an inappropriate collateral attack on FERC's orders approving the RPM mechanism, and asserts that RPM Buyers' do not provide empirical evidence of market power that would warrant further inquiry. Moreover, the relief requested, if granted, would "deal a damaging blow to investor faith in Commission-regulated forward markets." They note that the implementation of RPM follows intensive negotiations and a Commission-approved stakeholder-supported settlement agreement. It represents "a comprehensive

approach to the reliability challenge that contains many improvements over the pre-existing capacity construct. But it is not the last word.” They acknowledge that the challenges raised by RPM Buyers’ are important to further improve the reliability construct. PJM states that it is “committed to a thorough forward-looking review of RPM, including examination of the types of issues RPM Buyers have raised....” They argue, however, that RPM Buyers’ analysis is inappropriately backward-looking, and urge the Commission to reject the complaint for a number of reasons:

- RPM Buyers’ arguments ignore the filed rate doctrine and prohibition on retroactive ratemaking;**
- The requested remedy puts FERC in the position of arbitrarily crafting prices unrelated to seller offers;**
- Were refunds to be ordered, contract certainly needed for capital-intensive investment would be undermined and the development of the forward electricity markets would be crippled; and**
- Granting the requested relief would erode the value of FERC-approved settlements by allowing parties who agreed, or did not object, to a settlement to re-litigate settled issues.**

Additionally, PJM argues that granting RPM Buyers’ relief would signal the Commission’s lack of faith in auction results that PJM’s MMU has found to be consistent with expectations from a competitive market.

Other comments

More than 50 parties intervened in the proceeding. Those siding with the RPM Buyers simply state their support for the relief requested in the complaint. The common theme in a number of oppositions to RPM Buyers’ request echoes the arguments raised by PJM: the complaint is an impermissible collateral attack on FERC’s orders approving the RPM settlement, and allowing refunds would result in inequitable harm to market participants and weaken the certainty required for efficient market operations. Several

comments, including those by the PJM Power Providers Group and Duke Energy and Reliant Energy assert that the transition auctions operated precisely as designed and were consistent with the models submitted to and approved by FERC in connection with the settlement proceeding. EPSA calls the complaint a case of “buyers remorse,” while Shell Energy and a group calling itself the Demand Response and Advanced Metering Coalition each point out that although transitional auction prices have been higher than anticipated, for many years PJM markets did not provide any signals indicating a need for additional supply.

FERC has not yet taken action in this proceeding.

**B. FERC Reaffirms Rules on Open Access Transmission:
Order No. 890-B (Docket Nos. RM05-17, RM05-25, OA08-62)**

On June 23, 2008, FERC largely reaffirmed its rules on open access transmission. 123 FERC ¶61,299. In this recent order, FERC affirms, and in some cases clarifies the methodology for calculating ATC; standardization of energy and generation imbalance charges; rollover rights and rules regarding the designation (and undesignation) of network resources.

Order Nos. 890 and 890-A

On Feb 16, 2007, the Commission issued Order No. 890 amending its regulations and the *pro forma* open access transmission tariff (OATT) adopted more than a decade ago. 118 FERC ¶61,119. Some of the specific requirements for transmission providers include:

- A requirement for public utilities, working with the NERC and the NAESB, to develop consistent ATC calculation methodologies within one year and to publish those methodologies to increase transparency. FERC emphasized that transmission providers will not be required to use a single calculation methodology, but they will have to ensure that data and modeling assumptions be consistent. Each transmission

provider will be required to include its methodology on its OATT and to post all relevant data on its OASIS.

- Coordinated, open transmission planning process, on both local and regional levels, in which each transmission provider must meet nine specified planning principles: coordination, openness, transparency, information exchange, comparability, dispute resolution, regional coordination, economic planning studies and cost allocation. The goal is to include in this process new sources of energy and transmission alternatives. Customers are also to be included in this planning process. Descriptions of the planning process are to be included in the transmission provider's tariff.
- Transmission pricing reforms including reforms to the pricing of energy and generator imbalances to require such charges to be related to the cost of correcting the imbalance, to encourage efficient scheduling behavior and to exempt intermittent generators, such as wind power producers, from higher imbalance charges in recognition of the special circumstances presented by such resources. Other pricing reforms include elimination of a price cap on customer reassignments of point-to-point transmission capacity, and customer credits for construction of jointly planned facilities.
- Inclusion of a conditional firm component to long-term point-to-point service addressing situations in which firm service can be provided for most, but not all, hours of the requested time period. The rule also reforms the existing requirements for redispatch service to ensure that the requirements are of greater use to transmission customers and more consistent with reliable planning and operation of the system.
- Revisions to OATT provisions addressing rollover rights including a five-year minimum contract term. Customers will be required to provide notice of their intent to exercise a right of first refusal to renew a contract at least one year before the transmission service agreement expires.
- A requirement that transmission providers post on their OASIS all business rules, practices and standards related to transmission services provided under the *pro forma* OATT.

On December 28, 2007, FERC issued an order on rehearing (Order No. 890-A) largely affirming Order No. 890. 121 FERC ¶61,297. Among issues addressed in the lengthy rehearing order, FERC responded to challenges to the Commission's decision to revoke market based rate authority following an OATT violation only where it finds a specific factual nexus between the violation and the authority to charge market based rates. With respect to available transmission capacity (ATC), FERC clarified that transmission providers will be able to retain some discretion

with ATC calculations provided that there is industry-wide consistency regarding ATC components. Order 890-A also affirmed FERC's decision to lift the price cap on reassignments of transmission capacity, but limited the time period during which reassignments may occur above the cap.

Order No. 890-B

Order 890-B largely reaffirms the previous rulings, with a few notable changes:

ATC calculation : Despite protests, FERC remained steadfast in its insistence on consistency of ATC components and data inputs for adjacent transmission providers. “[I]f all of the ATC components and certain data inputs and assumptions are consistent, the ATC calculation methodologies being finalized by [the North American Electric Reliability Corp.] through the reliability standards development process should produce predictable and sufficiently accurate, consistent, equivalent, and replicable results.”

Affiliate requests for information: One goal of the OATT reforms is to increase transparency of how load forecasts are made so that it is clear “that loads are consistently being forecast using methodologies which are not subject to daily manipulation to favor affiliates.” Certain commenters had expressed concern about posting some of the types of information that an affiliate might request. FERC clarified that with respect to such requests, if the requested information is already publicly available, the transmission provider need not post the actual information, but only a notice that an affiliate requested the information. Additionally, transmission providers are to post the factors used to make load forecasts that have a significant impact on those calculations and “not all economic and other data that underlies each and every daily load forecast.”

Energy and generation imbalance service: With respect to generation imbalances, FERC affirmed that only the maximum amount of generator imbalance service that can be offered without impairing reliability needs to be posted, but imbalance service must be sought from other sources “in a manner that is reasonable in light of the transmission provider’s operations and the needs of its imbalance customers.” FERC denied requests to limit the time frame for this posting, since what is “reasonable” will vary according to the circumstances. Additionally, where a transmission provider lacks access to resources sufficient to meet its obligation to provide generator imbalance service, it must accept – but cannot require – use of dynamic scheduling by a customer.

Credits for new facilities: FERC clarified that it will create a rebuttable presumption that new customer-owned facilities that are similar in scope and design

to transmission provider facilities that are “in rates” are integrated with the greater grid and therefore eligible for rolled-in rate treatment.

Allocation of excess capacity created by system upgrades: FERC clarified that customers supporting upgrades, whether through direct assignment or rolled-in pricing, will not have their upgrades sized based on the needs of planning redispatch and conditional firm customers that opt not to support upgrades. However, FERC reversed its previous determination with respect to how excess capacity created by system upgrades will be allocated among transmission customers, preferring to address this issue if and when such a situation in fact arises.

Transmission rollover rights: FERC revised tariff language dealing with transmission rollover rights. Customers rolling over their service must accept contract terms that are at least equal to competing requests.

Point-to-point and network transmission service: A transmission customer may use both point-to-point and network transmission service, however use of point-to-point service does not decrease the size of the network customer’s load for purposes of calculating its load ratio share payment obligations, except to the extent the discrete load being served has been excluded in its entirety from network service.

The final rule applies to all public utility transmission providers, including regional transmission organizations and independent system operators. Each is required to file revisions to its OATT to conform to the Orders, however FERC will accept existing terms and conditions of open access service if it is demonstrated that they are consistent with, or superior to, the *pro forma* OATT as outlined in the final rule.

C. FERC approves modifications to RTO/ISO demand response programs

(i) PJM (Docket No. ER08-824)

On June 12, 2008, FERC conditionally approved revisions proposed by PJM LLC to modify its Economic Load Response Program (ELRP) to disallow demand response payments to program participants for load reductions that are due to normal operations rather than market price signals. 123 FERC ¶61,257. In its request, PJM described an increase in disputes arising when electric distribution companies and LSEs deny demand

response settlements where there is some question about whether a reduction in load represented a normal change in usage. To address the problem, PJM proposed to change its methodology for calculating weekday customer baseline load. Previously, PJM used a “flat average” approach that looks to the five highest-usage days out of a 10-day period. According to PJM, this methodology “has the potential to miss the normal low-usage periods for highly variable loads” Among the changes, PJM will calculate the baseline based on the highest four of the five most recent usage days within the 45 days preceding the day of curtailment. According to PJM, this will result in improved accuracy because the baseline days will be closer to the curtailment day and the average over four days will mitigate the effect of any particular day. PJM also requested authority to sanction a demand response participant for repeated violations of program rules. Among other approved changes are: a requirement that load reductions be in response to price in order to receive credit; the establishment of a list of activities that will not be considered demand response; and a requirement that demand response providers give notice if normal operations will cause a significant change in customer baselines.

(ii) ISO-NE (Docket No. ER08-830)

On June 13, 2008 FERC approved changes to ISO New England’s (“ISO-NE”) demand response rules which would lower the current heat rate index for the program. 123 FERC ¶61,266. ISO-NE explained that the change was needed because the current heat rate, calculated based on 2002 natural gas prices, is outdated.

Under the ISO-NE’s Day-Ahead Load Response Program (DALRP), a participant may offer to reduce load in real time if day-ahead LMP clears at a level equal to or above the participant’s offer price. In April of this year, after the grid operator noticed that outdated

prices allowed generators to game the system, FERC approved an increase in the minimum offer price, tying it to an index designed to reflect current fuel prices.

FERC found that although the methodology in the ISO-NE's latest proposal is not ideal for all participants, it is an acceptable trade-off between baseline accuracy and DALRP participation, restricting DALRP payments to periods of high LMPs while continuing to protect customers from being charged for services that are not in fact provided.

FERC also noted that ISO-NE will conduct a review its demand response programs beginning in October 2008, and directed ISO-NE to provide a report of the findings from the review by February 26, 2009, including a timetable of proposed additional changes if appropriate.

The revised heat index went into effect on July 1.

(iii) NYISO (Docket No. ER04-230)

On June 25, 2008, FERC approved the NYISO's new credit requirements for demand-side resources seeking to participate in the ancillary services market. 123 FERC ¶61,306. Previously, FERC had rejected the grid operator's proposal to impose new credit requirements on demand resources when it approved the demand-side ancillary service program ("DSASP") on the basis that the NYISO had not adequately justified the requirements; however FERC told the NYISO that it could re-file the proposal with adequate justification within 60 days.

As the NYISO explained in its compliance filing, the requirements are designed to ensure that the grid operator will be able to obtain sufficient collateral from Demand Side Resources offering ancillary services to cover any potential net negative financial positions

that could arise from their participation in the markets. "Unpaid negative financial positions can create a bad debt loss that would be spread market-wide," and states that the proposed credit requirements reasonably reflect the extent of this potential bad debt loss by estimating the actual market settlements a Demand Side Resource may experience based on its scheduled ancillary services market activity and the time of year. NYISO explains that the credit requirements would be set at levels based on empirical information, i.e., data on activity in the relevant ancillary services market for the same two-month period during the prior year.

As it does in developing all of its credit requirements for market participants, the NYISO posited a worst-case scenario "in order to maximize the protection against market-wide bad debt loss." Here, the ISO assumed a situation where a demand side resource completely fails to perform when called upon, the real-time market clearing price on which its balancing obligation would be paid exceeded the day-ahead MCP it was paid, and the resource continued to bid, continued to be paid and continued not to perform until the NYISO could suspend its market activity.

FERC also clarified that that when it rejected the credit rules in May subject to re-filing, it did not intend that demand resources could participate in the ancillary services market without any applicable credit rules in place.

D. FERC establishes guidelines to evaluate NERC Violation Severity Levels (FERC Docket No. RR08-4)

On June 19, 2008, FERC approved NERC's proposed schedule of violation severity levels ("VSLs") to be used to assess violations of reliability requirements and determine monetary penalties, where appropriate. 123 FERC ¶61,284. The plan would rank

violations of reliability standards among four levels of severity. Base penalty ranges would be computed by referencing the VSL against severity levels for each of the reliability standards. Examples of a “severe” violation would include failure of a regional reliability organization to assign reliability coordinators, or failure of a utility to notify a reliability coordinator that it would be unable to follow a reliability directive.

FERC explained that, similar to Violation Risk Factors, the VSLs are not part of a Reliability Standard in that they do not set forth requirements with which an entity must comply, but will be used to assess gravity of noncompliance with requirements.

In approving the scheme, the Commission expressed concern regarding consistency and objectivity in interpreting the VSLs, and so included in its order certain guidelines for evaluating the validity of VSL assignments:

- 1. VSL assignments should not have the unintended consequence of lowering the current level of compliance;**
- 2. VSL assignments should ensure uniformity and consistency among all approved reliability standards in the determination of penalties;**
- 3. VSL assignments should be consistent with the corresponding requirement; and**
- 4. VSL assignments should be based on a single violation, not on a cumulative number of violations.**

Adjustments of penalty levels for repeat violations will be considered separately as part of NERC’s penalty guidelines.

FERC ordered NERC to revise the VSLs so that they comply with the established guidelines, or to explain (and justify) any inconsistencies. NERC was also ordered to revise the VSLs with respect to five standards developed to implement recommendations of the joint U.S.-Canada task force that studied the August 2003 northeast blackout.

II. COURT PROCEEDINGS

A. Supreme Court expands Mobile Sierra doctrine in *Morgan Stanley Capital Group Inc. v. Public Util. Dist. No. 1 of Snohomish County et al.*

On June 26, the Supreme Court issued its decision on whether certain electric power contracts entered during the 2000-2001 western markets energy crisis should be abrogated or revised. *Morgan Stanley Capital Group Inc. v. Public Util. Dist. No. 1 of Snohomish County*, Nos. 06-1457 and 06-1462, 2008 U.S. LEXIS 5226, (2008). The decision:

1. affirmed and expanded the *Mobile-Sierra* doctrine that all arms-length, wholesale electricity contracts are presumed to be “just and reasonable” unless FERC concludes that the contract “seriously harms” the public interest;
2. held in particular that the *Mobile-Sierra* doctrine applies (1) to purchasers as well as sellers seeking relief from a contract, (2) even if FERC had not specifically reviewed contract terms when they were adopted, and (3) even to those contracts entered into during periods of market dysfunction;
3. directed FERC to assess long-term as well as short-term effect on consumer prices in assessing whether a contract “seriously harms” the public interest under the *Mobile-Sierra* doctrine; and
4. held that no contract would exist, and therefore the *Mobile-Sierra* doctrine would not apply, “if it is clear that one party to a contract engaged in such extensive unlawful market manipulation as to alter the playing field for contract negotiations.”

The Supreme Court’s decision represents a victory for the sanctity of contracts, but is a setback to buyers who would argue for contract reformation where market dysfunctions have a significant impact contract prices. Going forward, in evaluating whether contract rates are just and reasonable, FERC will likely limit review to circumstances where the public interest is clearly affected or where there is evidence that one party’s misconduct has impacted the negotiations (and outcome) of the resulting contract between the buyer and seller. The ruling may also bring an end to some pending

refund requests based on general spot market manipulation where neither party to a contract was involved in the misconduct. On the other hand, the Supreme Court left open a crack in the door for a party to seek review at any point during the term of a contract based on either misconduct such as market manipulation or on rates that over the long-term would result in serious harm to the public interest.

Background to the Snohomish Challenge

Under the Federal Power Act (FPA), a selling public utility can propose rates and FERC can approve them if it finds they meet the “just and reasonable” standard. Freedom of contract, however, allows selling utilities to voluntarily restrict some or all of their freedom to change the contract rates, and allows customers to agree to restrict their right to request the Commission to change the rate. The term *Mobile-Sierra* refers to two 1956 U.S. Supreme Court decisions providing that when private contracts set firm rates or establish a rate methodology and deny either party the right unilaterally to change those rates, the contracted-for rates can be modified by the Commission only if required by the public interest.⁵

FERC issued numerous orders imposing refunds arising from the 2000-2001 crisis in the western energy markets, but in June 2003 denied an application filed by Snohomish Public Utility District No. 1 and certain other forward contract buyers to modify or terminate long-term contracts entered into in 2000 at a time when electricity prices were exorbitant and the markets were dysfunctional. FERC ruled that the buyers in question

⁵ *United Gas Pipeline Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956); *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956). As the U.S. Supreme Court stated in *Sierra*, “while it may be that the Commission may not normally *impose* upon a public utility a rate which would produce less than a fair return, it does not follow that the public utility may not itself agree by contract to a rate affording less than a fair return or that, if it does so, it is entitled to be relieved of its improvident bargain.” 350 U.S. at 345-55.

failed to meet the “public interest” standard for contract modification because the contracts were not unduly discriminatory and would neither cause complainants to fail financially nor impose an excessive burden on ratepayers. FERC found that “once a party signs a *Mobile-Sierra* contract, it cannot escape by later claiming that the rates were not just and reasonable when it signed the contract” absent evidence of fraud. The fact that over time the contracts had become uneconomic did not render them contrary to the public interest. FERC reasoned that it would create uncertainty in the market if a party who found that its deal had become uneconomic could readily undo the contract. This principle should apply even in a market-based rate regime. According to FERC, while prospectively market-based rates must be just and reasonable, if rates subsequently become unjust and unreasonable and if the contract is subject to the *Mobile-Sierra* standard of review, the Commission cannot change the contract merely because the contracted for rates are no longer just and reasonable.

Snohomish and the private forward contract buyers sought judicial review of FERC’s decisions. They contended that the western spot market dysfunctions carried over into the long-term bilateral market, forcing some suppliers into contracts at prices so high as to be unjust and unreasonable. FERC could not ignore that, at the time the forward contracts at issue were entered into, its own Staff Report had found that the markets were dysfunctional. FERC, for its part, emphasized the strength of the policy interest in protecting the sanctity of contracts. FERC contended that because it requires a showing of lack of market power before granting market-based rate authority to sellers and regular reporting, its oversight role is sufficiently fulfilled.

The Ninth Circuit's Decision

The Ninth Circuit's December 19, 2006 decision reversed FERC's ruling.⁶ The Ninth Circuit noted that when *Mobile-Sierra* was adopted, FERC approved individual contracts. In contrast, under the current market-based rate regime, FERC pre-approves market-based rates on the basis that the seller has no market power. The court applied a tripartite analysis in considering whether forward contracts entered into during the western markets crisis (and under FERC market-based rate authority) were just and reasonable.

First, the court considered whether the contracts were subject to *Mobile-Sierra* review. Since the contracts called for or were silent with respect to applicability of the *Mobile-Sierra* standard, the court agreed with FERC that as a contractual matter the *Mobile-Sierra* standard could be applied.

Second, the court focused on whether FERC's market-based rate authority process allowed for timely and effective review of rates and found that FERC's review did not pass muster. The court found that market-based rate authority can qualify as sufficient prior review to justify limited *Mobile-Sierra* review only "when accompanied by effective oversight permitting timely reconsideration of market-based authorization if market conditions change." Here, the fatal flaw in FERC's approach to "oversight" is that "it precludes timely consideration of sudden market changes and offers no protection to purchasers victimized by the abuses of sellers or dysfunctional market conditions that FERC itself only notices in hindsight."

⁶ *Pub. Util. Dist. No. 1 of Snohomish County v. FERC*, 2006 U.S. App. LEXIS 31297 (9th Cir. 2006). The Ninth Circuit also issued a similar decision in a companion case: *Pub. Util. Comm'n of Cal. v. FERC*, 2006 U.S. App. LEXIS 31140 (9th Cir. 2006).

Third, the Ninth Circuit held that FERC erred by adhering to *Mobile-Sierra* without considering market conditions at the time the contracts were formed: “*Mobile-Sierra* cannot apply without 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.” Having acknowledged in its Staff Report that the western markets were dysfunctional when the contracts under review were formed, FERC failed to consider whether the influence of the spot markets on the forward markets reached a level sufficient to raise the question whether two parties could negotiate a just and reasonable contract triggering the *Mobile-Sierra* presumption. The Ninth Circuit found that FERC should have considered whether the contracts in question were entered into in fully functioning markets as a prerequisite to whether *Mobile-Sierra* should apply. Furthermore, the court found that FERC compounded the error by applying *Mobile-Sierra* analysis taken from the context of low-rate challenges to high-rate challenges. In a *low-rate* case, the important “public interest” concerns relate to the selling utility’s solvency and assuring that under recovered costs are not recouped from other customers. In contrast in a *high-rate* challenge, the public interest requires that the consuming public not be required to pay a rate so high that it falls outside a “zone of reasonableness.”

The Supreme Court’s Ruling

Justice Scalia, writing for the majority, noted that the Supreme Court was in broad agreement with the central premises of the Ninth Circuit’s decision – *i.e.*, that the just and reasonable standard is the only statutory standard that applies when assessing wholesale electricity rates, whether set by contract or tariff, and that the components of the “public

interest” that may justify contract reformation are not evaluated identically in low rate and high rate cases. However, the Supreme Court took issue with the Ninth Circuit’s interpretation of how and when FERC is to apply the *Mobile-Sierra* standard.

(a) *Mobile-Sierra applies to all negotiated wholesale power contracts irrespective of when rates are challenged*

The Supreme Court disagreed with the Ninth Circuit’s view that under the *Sierra* decision “as long as the rate was just and reasonable when the contract was formed, there would be a presumption ... that the reasonableness continued throughout the term of the contract.”⁷ This interpretation, the Supreme Court said, essentially amounts to an estoppel doctrine, when, in fact, *Sierra* simply “provided a definition of what it means for a rate to satisfy the just and reasonable standard in the contract context -- a definition that applies regardless of when the contract is reviewed.”⁸ In the market-based rate context, where the Commission exercises only a “passive” review of rates, the Supreme Court said it would be particularly “odd to treat that initial ‘opportunity for review’ as curtailing later challenges.”⁹ Rather, a single standard of review applies regardless of when the rate is challenged. In a proper regulatory scheme, all contract rates should be evaluated on the basis of whether the rates seriously harm the public interest and not whether they are unfair to the parties who voluntarily entered into the contract.

Moreover, the Supreme Court disagreed with the Ninth Circuit’s ruling that FERC should take account of market dysfunction when applying the *Mobile-Sierra* doctrine.

While FERC always has the ability to set aside contracts that harm the public interest --

⁷ 471 F.3d, at 1077.

⁸2008 U.S. LEXIS 5266 at *30.

⁹ *Id.* The Supreme Court noted that the Ninth Circuit and the D.C. Circuit have generally approved FERC’s market-based rate regime but observed that this issue is not before it here. *See id.*, at *17.

including contracts where there is unfair dealing during the negotiations -- it is precisely because markets are imperfect that contracting is encouraged. To render contracts between sophisticated parties less likely to be enforced during period of market volatility would chill the incentive to enter contracts in the first place.

(b) Standards for challenges by buyers and sellers are treated equally

The Supreme Court also disagreed with the Ninth Circuit's proposition that the standard for overcoming the *Mobile-Sierra* presumption in a buyer's challenge to high rates is different from that for a seller's challenge to low rates. While the various factors to be considered in evaluating whether a contract rate is just and reasonable may be different in high and low rate challenges, the standard to be applied in either situation is whether the contract rate seriously harms the public interest. The mere fact that a rate exceeds marginal cost does not necessarily mean it imposes an "excessive burden" on consumers nor does it render the rate contrary to the public interest. The Supreme Court said that the Ninth Circuit's "zone of reasonableness" test for high rate cases -- whereby a rate could be set aside if consumers were forced to pay prices higher than they would have been had the contract rate been equal to marginal cost -- would amount to re-institution of a cost-based rate regime and would impose an enormous burden on the Commission to evaluate cost and other factors surrounding all contracts.

(c) Remand order

The Supreme Court remanded to FERC for further consideration of two points. First, the Supreme Court was unable to discern whether the Commission considered the long-term burden the contract rates imposed on consumers relative to rates that could have been obtained, but for the contracts, once the market dysfunction was resolved. In other

words, FERC must consider not only the burden imposed at the outset of the contract, but also over the course of the contract period. If, during the time the contract rate is in force, the disparity between the contract rate and the market rate is so great as to impose an “excessive burden” on consumers or otherwise seriously harm the public interest, then “even taking into account the desirability of fostering market-stabilizing long-term contracts, ... the rates must be disallowed.”¹⁰ The Supreme Court reasoned that the “unequivocal public necessity that justifies overriding the *Mobile-Sierra* presumption does not disappear as a factor once the contract enters into force.”¹¹

Second, the Supreme Court emphasized that fact that a party engaged in unlawful activity in the spot market does not deprive its forward contracts of the benefit of the *Mobile-Sierra* presumption absent a finding of a causal connection between the unlawful activity and the rates set in its contracts; however where it is clear that the party’s market manipulation was so extensive as to alter the playing field for contract negotiations, FERC should not presume the contract is just and reasonable:

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. The mere fact that the unlawful activity occurred in a different (but related) market does not automatically establish that it had no effect upon the contract – especially given the Staff Report’s (unsurprising) finding that high prices in the [spot] market produced high prices in the

¹⁰ *Id.*, at *43.

¹¹ *Id.*, at *42.

[forward market].”¹² The Supreme Court directed FERC to clarify whether such a causal connection had been found in the particular contracts it is ordered to review on remand.

(d) The dissent

Justices Stevens and Souter dissented, asserting that the majority engaged in policy-making and arguing that *Mobile-Sierra* is not a different application of the “just and reasonable” standard, but rather a different standard all together, and one that runs afoul of the FPA.¹³ They state:

The statute does not say anything about a mandatory presumption for contracts, much less define the burden of proof for overcoming it or delineate the circumstances for its nonapplication... .

If Congress had intended to impose such detailed constraints on the Commission’s authority to review contract rates, it would have done so itself in the FPA. Congress instead used the general words “just and reasonable” because it wanted to give FERC, not the courts, wide latitude in setting policy.

...

[O]ur cases interpreting the FPA have invariably emphasized that courts are without authority to set aside any rate adopted by the Commission which is within a ‘zone of reasonableness.’ ... This deference makes eminent sense because rate-making agencies are not bound to the service of any single regulatory formula; they are permitted, unless their statutory authority otherwise plainly indicates, to make the pragmatic adjustments which may be called for by particular circumstances.¹⁴

The dissenters further state that had Congress intended to shield contract rates from the statutorily-mandated “just and reasonable” review, it would have said so explicitly. In their view, both *Mobile* and *Sierra* support this proposition. *Mobile* says nothing about the

¹² *Id.*, at *44.

¹³ They also question the majority’s use of the term “*Mobile-Sierra* doctrine,” arguing that no such “doctrine” or “presumption” in fact can be gleaned from the precedent.

¹⁴ *Id.*, at *50-*51 (Justice Stevens, dissenting) (internal cites omitted).

standard of review that applies to rates established by contract. Rather, it says that a utility may not abrogate a contract with a buyer simply by filing a new rate with FERC. *Sierra* says that the public interest is a factor to be considered in just and reasonable review of all rates, not just contract rates. Neither case, they argue, says anything about symmetric treatment of low-rate or high-rate cases, and neither case, nor their progeny, lead to the conclusion that just and reasonable rates can be determined by reference to market prices.

Moreover, the dissent argues, even if the majority were correct in its application of the *Mobile-Sierra* precedent, FERC's orders must be set aside because the Commission itself admits it was applying a public interest standard "different from and more demanding than the statutory standard." Instead of focusing on whether the rates were just and reasonable, FERC acknowledged that its review was largely behavioral and that it did not believe it was permitted to consider evidence relevant to the reasonableness of the rates, such as the influence of the spot market on the forward contract prices, because it was operating under a heightened standard of review.

**B. Challenge to FERC's PURPA Sec. 210(m) Implementation Rules
(U.S. Court of Appeals for the D.C. Circuit, Case No. 07-1328)**

On August 16, 2007, the AF&PA filed a petition for review in the D.C. Circuit challenging FERC's new rules implementing PURPA Section 210(m) establishing the procedures and conditions under which a utility may seek relief from PURPA mandatory QF purchase obligations. (Order Nos. 688, 117 FERC ¶61,078 (October 20, 2006) and 688A, 119 FERC ¶61,305, (June 22, 2007).)

The rules in question represent FERC's fulfillment of Congress' mandate in EAct 2005 to grant utilities waivers from the PURPA QF purchase obligation if certain conditions described in the statute are met. On rehearing, FERC rejected the argument that Congress intended that there be a meaningfully competitive market prior to terminating a QF's purchase obligation and that such markets that do exist are predominantly for resale and very short-term. In a key passage, FERC asserted: "Congress could have stated a broad general finding to be made by the Commission such as 'workably competitive markets.' Instead Congress tailored subparagraphs (A) and (B) to establish criteria specific to each market design...". Order No. 688-A at para. 47. "While it is true that EACT 2005 did not repeal PURPA or the Commission's obligations to encourage QF development, enactment of section 210(m) of PURPA clearly changes the rights of QFs under PURPA. The Commission has no discretion other than to terminate the purchase requirement if it finds that a QF has nondiscriminatory access... It would be inappropriate for the Commission to ignore this mandate... in a way that undermines the specific standards of relief that Congress chose to establish in the statute." *Id.*, at para. 48.

FERC stressed most heavily the different standard that Congress applied in Section 210(m)(1)(B)(ii) which requires a finding of access to "competitive wholesale markets that provide a meaningful opportunity to sell capacity, including long-term and short-term sales, and electric energy including long-term, short-term and real tie sales." Such language is not contained in (A)(ii) which only requires access to markets. Order No. 688-A, at para. 24. Even if Day 2 long-term markets are nascent, Congress in (A)(ii) only required that the Commission find that they exist, not that they be robust. *Id.*, at paras. 26, 28. Without much rationale, FERC also found that the one-year term used for EQR reports is sufficient to meet the statutory requirement that there be

“wholesale markets for long-term sales of capacity and energy” within the meaning of section 210(m)(1)(A)(ii). *Id.*, at para. 27.

AF&PA filed their petitioner’s brief on May 15, 2008. The brief focuses on analysis of the statutory language. It closely tracks the legal arguments made in AF&PA's rulemaking comments that FERC's reading of 210(m) with respect to the Day 2 markets is inconsistent with the plain language of the statute that all markets must be competitive and is untenable when viewed in the context of the other parts of 210(m), including the standards for utility relief in (m)(3) and for QF relief in (m)(4). AF&PA argues that FERC’s reading of the statute is nonsensical -- Congress could not have intended for meaningless, noncompetitive markets to meet the statutory definition:

The Commission’s interpretation makes nonsense out of key pieces of the Statute. If meaningless, noncompetitive markets are enough to meet the requirement of §210(m)(1)(A)(ii), then §210(m)(1)(C) – which requires markets “of *comparable competitive quality* as the markets described in paragraph (A) [which the Commission believes may be meaningless and noncompetitive] and (B) [which must be “competitive” and feature a “meaningful opportunity to sell”] – is incoherent. If meaningless, noncompetitive markets are enough under §210(m)(1)(A)(ii), then §210(m)(3) -- requiring utilities seeking relief from the Mandatory Purchase Obligation to “set forth the *factual basis* upon which relief is requested and describe why the conditions set forth in subparagraphs (A), (B) of (C) of paragraph (1) of this subsection have been met” – is likewise deprived of significance, since under the Commission’s interpretation of the term “markets” there is no factual basis upon which a QF could demonstrate that the markets required under (A) do not exist. Under the Commission’s interpretation §210(m)(4), which again requires a “factual basis” for concluding that the requirement of (A)(ii) is met, suffers the same incongruous fate.

On May 30, 2008, ELCON filed a brief as *amicus curiae* in support of AF&PA.

ELCON’s arguments focus on two issues relating to long-term contracting: FERC failed to properly apply the statutory criteria and failed to properly address comments specifying the

nature of the long-term contracting needed to support the special operating characteristics of QFs.

First, ELCON asserts that FERC erred as a matter of law in concluding that the mere existence of the so-called “Day 2 markets” and, on rehearing, its reference to evidence of some bilateral contracting in those markets, satisfies the statutory standard of *non-discriminatory access* to *long-term* contract opportunities. The Day 2 markets are in their infancy. FERC itself recognized in two contemporaneous rulemakings that the absence of a forward market is in fact one of the principal problems confronting the nascent wholesale markets.

Second, ELCON argues that FERC erred in defining “long-term” contracts for purposes of section 210(m) as those with a duration as short as one year, based merely on selective reference to inapposite FERC precedent. FERC failed to grapple with comments by ELCON and others establishing that contracts of on the order of five years duration are important to support investment in and construction of cogeneration facilities and other QFs, particularly in view of their special characteristics for dispatch of electricity. In the absence of a statutory definition or legislative history, FERC should be guided by the purpose of section 210(m), which was not to remove incentives to QFs -- important as they are to the electricity grid and achievement of improved energy efficiency -- but rather to establish conditions whereby the deregulated wholesale markets can properly serve as a reasonable substitute for the mandatory purchase obligations of PURPA that otherwise would apply.

Oral argument has not yet been scheduled but is anticipated to be this fall, as final briefs are due in early September.

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