Avoiding the Road to FERC-dom: The Supreme Court affirms the right to contract in Morgan Stanley v. Snohomish

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1. Introduction

Competition is superior not only because it is in most circumstances the most efficient method known [1] but even more because it is the only method by which activities can be adjusted to each other without coercive or arbitrary intervention of authority. . . .

That was Freidrich Hayek’s admonition against centralized planning and regulation. [1] In the case of Morgan Stanley v. Snohomish [2] the Supreme Court had to decide how much regulation is too much regulation. The Supreme Court correctly decided that abrogating contracts entered into freely by sophisticated parties is clearly too much. But first a bit of background.

It is black-letter law that rates charged for electric generation capacity must be “just and reasonable.” The Federal Energy Regulatory Commission (“FERC”) [3] has long been the arbiter of that standard. Nevertheless, buyers and sellers of electricity have also been permitted to enter into their own rate agreements. When parties enter into bilateral rate agreements, the Mobile–Sierra doctrine applies. Under the Mobile-Sierra doctrine, FERC must presume that any rate set forth in a freely-negotiated contract meets the “just and reasonable” requirement. That presumption may only be overcome if FERC concludes the contract seriously harms the public interest. Thankfully, the Supreme Court upheld the doctrine and preserved the freedom to contract.

[3] FERC’s predecessor was the Federal Power Commission. For ease of reference, we will simply refer to both as FERC.
To understand the significance of the ruling, we will first briefly explain the genesis of the Mobil-Sierra doctrine (which was born out of the power laws of the United States) and then the factual and procedural details of Morgan Stanley v. Snohomish. Finally, we will analyze the importance of the holding in the broader context.

2. **History of the Federal Power Act (“FPA”)**

   The market for electricity was historically characterized by natural monopoly—that is, monopoly that exists because of the high start-up costs in the industry. Naturally, a monopolistic industry is subject to abuses by those with market power. As a consequence, Congress passed the FPA. The goal was to “produce an abundance of electricity at the lowest possible cost.” The FPA gave FERC exclusive jurisdiction over wholesale electric-energy transmission by public utilities in interstate commerce. The FPA requires regulated utilities to file rate-schedule compilations, or tariffs, with FERC and to serve electricity purchasers on the terms and prices set forth in those schedules. According to the FPA, the as-filed rates become effective automatically unless FERC rejects or suspends them. The statute requires utilities wanting to change their tariffs to tell FERC 60 days before the change is supposed to go into effect. More importantly, the FPA requires all wholesale-electricity rates to be “just and reasonable” and any rate “that is not just and reasonable is . . . declared to be unlawful.”

The FPA legislates when FERC can affirmatively set aside wholesale-energy rates. In

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4 *Morgan Stanley*, 554 U.S. at 531.
5 *Id.*
7 *See S. REP. NO. 74-621 at 17 (1935).*
8 16 U.S.C. § 824 (2012); *see also Morgan Stanley*, 554 U.S. at 531.
9 *Morgan Stanley*, 554 U.S. at 531.
11 *Id.* § 824d(d).
12 *Id.* § 824d(a).
fact, when a utility files a new rate, FERC may suspend the rate for five months and
investigate.\textsuperscript{13} And even after the rate goes into effect, whether FERC deemed it just and
reasonable or not, it may later conclude that the rate was not just and reasonable.\textsuperscript{14} FERC
thus has great power, so to speak.

So you may be asking yourself, what does “just and reasonable” mean? A good
question without a precise answer. The just and reasonable standard is very difficult to
define with precision. A survey of the cases dealing with this issue reveals that courts
give great deference to FERC in its rate decisions\textsuperscript{15}—in other words, no one formula
exists.\textsuperscript{16} It seems that the prime directive for the courts is to balance investor and
consumer interests.

But let’s get to the issue of freedom of contract. The FPA permits utilities to set
rates with individual electricity purchasers through bilateral contracts.\textsuperscript{17} In other words,
the FPA explicitly acknowledges that electricity buyers and sellers can use freely-
entered-into contracts in rate setting.\textsuperscript{18} Thus, it is fair to say that the statutory scheme
includes an avowal of the importance of private contracts.\textsuperscript{19}

Similar to the requirement for unilaterally-set tariffs, contracting parties must file
their contracts with FERC before they go into effect.\textsuperscript{20} But the FPA does not condition
the lawfulness of the rates on prior commission review and approval. Instead, rates based

\textsuperscript{13} Id. § 824d(e).
\textsuperscript{14} Id. § 824e(a).
\textsuperscript{16} Morgan Stanley, 554 U.S. at 532.
\textsuperscript{17} 16 U.S.C. §§ 824d(c) and (d).
\textsuperscript{18} Verizon Commc’n Inc. v. FCC, 535 U.S. 467, 479-480, 122 S. Ct. 1646, 1656 (2002) (departing from the
scheme of purely tariff-based regulation and acknowledging that contracts between commercial buyers and
sellers could be used in rate setting).
\textsuperscript{19} Sunray v. Mid-Con. Oil Co. v. Federal Power Comm’n, 364 U.S. 137, 154-55, 80 S. Ct. 1392, 1402
(1960).
\textsuperscript{20} 16 U.S.C. §§ 824d(c) and (d).
on forward contracts are valid unless FERC declares they are “otherwise” unlawful.\textsuperscript{21}

Which brings us to how FERC reviews rates set by arm’s-length contracts—the \textit{Mobile–Sierra} doctrine.

3. **History of the \textit{Mobile–Sierra} doctrine**

In two cases decided on the same day in 1956, the Supreme Court of the United States—through Justice Harlan—addressed in two separate cases (\textit{Mobile}\textsuperscript{22} and \textit{Sierra}\textsuperscript{23}, respectively) a regulator’s authority to modify rates set bilaterally by contract rather than unilaterally by tariff.\textsuperscript{24} \textit{Mobile} and \textit{Sierra} have become landmarks in energy law. The First Circuit has called them two of the “best-known public utility decisions by the Supreme Court in this century.”\textsuperscript{25}

In the \textit{Mobile} case, the Court held that “by requiring contracts to be filed with the Commission, the Act specifically recognizes that rates to particular customers may be set by individual contracts.”\textsuperscript{26} The Court also held that an energy provider (the case was decided under the parallel provisions of the Gas Act) could not abrogate a contract simply by filing a new tariff. In other words, the filing requirement is merely a precondition to changing a rate, not license to violate a lawful contract.\textsuperscript{27}

In \textit{Mobile’s} counterpart, \textit{Sierra}, the Court applied \textit{Mobile’s} holding to the FPA’s analogous provision.\textsuperscript{28} But \textit{Sierra} went even further. The Court also addressed the reach

\textsuperscript{21} \textit{Id.} § 824d(d).
\textsuperscript{22} \textit{United Gas Pipe Co. v. Mobile Gas Service Corp.}, 350 U.S. 332, 76 S. Ct. 373 (1956).
\textsuperscript{24} \textit{Id.} § 824d(d).
\textsuperscript{25} \textit{Boston Edison Co. v. FERC}, 233 F.3d 60, 66 (1st Cir. 2000).
\textsuperscript{26} \textit{Mobile}, 350 U.S. at 336. This made it different from the Interstate Commerce Act (“ICA”) because the ICA essentially precludes private-rate agreements because it requires that rates to all shippers be uniform.
\textsuperscript{27} \textit{Morgan Stanley}, 554 U.S. at 533.
\textsuperscript{28} \textit{Id.}
of FERC’s authority to change rates if it found them to be unjust.\textsuperscript{29} In \textit{Sierra}, FERC had
not only concluded that the newly-filed rate had superseded the contract, but that the
contract rate was not “just and reasonable” because it yielded less than a fair return on the
investment by the utility—a quite un-capitalistic finding.\textsuperscript{30} Thankfully, the Supreme
Court held that FERC must uphold the contract even if one party gets less than a fair
return on its investment.\textsuperscript{31} Just because a contract ends up being unprofitable to one side,
that losing party should not be allowed to breach the agreement.\textsuperscript{32} Even if FERC was
unable to “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 that a fair return or that, if it does so, it is entitled to be relieved of its improvident
bargain.”\textsuperscript{33}

According to Supreme Court, the only question to determine was whether the rate
was so low that it adversely affected the public interest.\textsuperscript{34} So this is where the Supreme
Court drew the line in the sand on too much regulation. The Court enunciated a three-
factor test to determine when a bad contract sufficiently affected the public interest: (1)
would the contract impose financial strain; (2) would the contract impose excessive
burdens on the customers; and (3) was the contract unduly discriminatory.\textsuperscript{35} The Court
has later further explained this test by saying that “the regulatory system created by the
[FPA] is premised on contractual agreements voluntarily devised by the regulated
companies; it contemplates abrogation of these agreements \textit{only in circumstances of}

\textsuperscript{29} \textit{Id.} at 353.
\textsuperscript{30} \textit{Id.} at 354-55.
\textsuperscript{31} \textit{Id.} at 355.
\textsuperscript{32} \textit{Id.} at 354.
\textsuperscript{33} \textit{Id.}
\textsuperscript{34} \textit{Id.} at 355.
\textsuperscript{35} \textit{Id.}
unequivocal public necessity."\textsuperscript{36} This standard is a compromise between the competing pulls of regulation and contract stability.\textsuperscript{37}

When reading the cases together, we see that FERC must presume that the rate set out in a freely negotiated contract meets the FPA’s just and reasonable standard. And that presumption does not depend on whether FERC had a prior opportunity to review the contract.\textsuperscript{38} A complaining party may overcome the presumption only if FERC concludes that the contract seriously harms the public interest.\textsuperscript{39}

So what has happened since \textit{Mobile} and \textit{Sierra}? Over the years, the Supreme Court has marched not in the direction of regulation but instead towards even greater freedom of contract. For example, the Court has said that parties can contract out of the \textit{Mobile-Sierra} presumption by specifying in their contracts that a new rate filed with FERC would supersede the contract rate.\textsuperscript{40} This shows the Court’s respect for the freedom of contract.

And it is not only the Supreme Court that favors freedom of contract—Congress does too. After \textit{Mobile} and \textit{Sierra}, Congress amended the FPA many times.\textsuperscript{41} Nevertheless, despite the unequivocally understood existence of the \textit{Mobile-Sierra} standard, it has declined to modify it or to expand FERC’s authority to review freely agreed to rate-setting contracts. It is fundamental that if Congress fails to change long-standing judicial precedent, it is akin to ratification. If not always, definitely here.\textsuperscript{42}

4. Market-Based Tariffs—All the More Reason to Allow Freedom of Contract

\textsuperscript{36} \textit{In re Permian Basin Area Rate Cases}, 390 U.S. 747, 822, 88 S. Ct. 1344 (1968) (emphasis added).
\textsuperscript{37} \textit{Mobile}, 350 U.S. at 344.
\textsuperscript{38} \textit{Morgan Stanley}, 554 U.S. at 546.
\textsuperscript{39} Id. at 548.
\textsuperscript{40} \textit{United Gas Pipe Line Co. v. Memphis Light, Gas and Water Div.}, 358 U.S. 103, 110-113 (1958).
Before we get to *Morgan Stanley v. Snohomish* there is one more general concept about the electricity market that must be understood—market-based tariffs.

For many years, electric utilities were vertically-integrated monopolies. As a result, FERC would assess whether a rate was just and reasonable based upon the cost of providing service plus a fair return on invested capital. Eventually, the cost of generating and transmitting electricity shrunk allowing more competition. In the late 80s, “power marketers” began entering the wholesale-energy market. Responding to the new players and to the technological changes enabling new entrants to pierce the historically monopolistic market, FERC decided to foster competition and free trade by minimizing barriers to market entry and permitted sellers to file market-based tariffs.

These tariffs, instead of setting forth rates schedules or rate-fixing contracts, simply state that the seller will enter into freely-negotiated contracts with purchasers. FERC approves market-based tariffs only if a utility shows that it lacks or has adequately mitigated market power, lacks the capacity to erect barriers to entry, and has avoided giving preferences to its affiliates. The concept is that in competitive markets, FERC may rely on these market-based prices instead of cost-of-service to ensure a just result. In reviewing applications, FERC undertakes an intensive factual review of geography, product, and market power.

43 *Morgan Stanley*, 554 U.S. at 535.
44 *Id.*
45 *Id.* at 537. FERC enacted these rates based on its authority under 16 U.S.C. § 824d(c).
47 FERC also requires ongoing reporting requirements such as filing quarterly reports. *See California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1013 (9th Cir. 2004).
48 *Consumers Energy Co. v. FERC*, 367 F.3d 915, 922-23 (D.C. Cir. 2004).
What is market power anyway? For one thing, it’s not easy to define. But courts have held that market power is the seller’s ability to “significantly influence price in the market by withholding service and excluding competitors for a significant period of time.”^50 Given how tough it is to define these issues, as a further safeguard, the seller’s application is subject to public and ongoing review.51

But market-based tariffs can only function if freely and fairly negotiated forward contracts are free from challenge. Thus, preserving the right to contract has become even more important.52 This is the only path to convincing investors that their capital investment is safe and secure. So now we get to Morgan Stanley v. Snohomish.

5. The Case at Hand—Morgan Stanley v. Snohomish—Factual and Procedural Background

A. Factual Background

Buyers can purchase a commodity in two ways: (1) on the “spot market” by paying the going price in exchange for contemporaneous delivery,53 or (2) on the “forward market” by entering into a long-term contract to pay for delivery of the commodity at a specified future date at a price fixed at the time of contracting.

Let’s go back to 1996. At that time, California tried to restructure its electricity market and move everyone to the “spot market.”54 The legislature established the California Power Exchange (CalPX)—a non-profit, centralized “spot market” for

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^51 For example, sellers are required to give the name of the buyer and seller, describe the service, the price, quantities involved, the duration of the contracts, and other things. British Columbia Power Exch. Corp., 99 FERC ¶ 61,247, at ¶ 62,066, 2008 WL 32035504, at *16-17 (2008).
electricity.\textsuperscript{55} California’s three largest investor-owned utilities were to divest (a very anti-capitalistic term in and of itself) most of their electricity-generating facilities.\textsuperscript{56} They were also obligated to buy most of their electricity on the spot market.\textsuperscript{57} Thus, when prices rose, the utilities paid the going rate for their power needs in the expensive spot market.\textsuperscript{58}

Fast forward to 2000: it was really, really hot; there was a drought; a major pipeline burst; more and more people demanded electricity; and run-down facilities did what run-down facilities do—they broke.\textsuperscript{59} And these were just a few of the problems California faced. So what happened? The perfect storm of mother nature’s uncooperativeness and broken facilities drove prices in the spot market to the highest levels ever—“[p]rices in California’s competitive wholesale electricity market increased by 500\% between the second half of 1999 and the second half of 2000. For the first 4 months of 2001, wholesale spot prices averaged over $300/MWh, ten times what they were in 1998 and 1999.”\textsuperscript{60} Predictably, because the investor-owned utilities had been restricted from getting power through long-term contracts, the turmoil in the spot-market caused many to drown in a sea of high prices.

In late 2000 FERC looked to the forward markets for help.\textsuperscript{61} FERC said that “eliminating any mandated reliance on the spot market represents the single most

\textsuperscript{55} Morgan Stanley, 554 U.S. at 539.
\textsuperscript{56} Id.
\textsuperscript{57} Id.
\textsuperscript{58} Id.
\textsuperscript{60} Paul L. Joskow, California’s Electricity Crisis, 17 OXFORD REV. ECON. POL’Y 365 (2001).
\textsuperscript{61} Morgan Stanley, 554 U.S. at 540.
important aspect of wholesale market reform.” It abolished the requirement to purchase electricity through CalPX and in a complete reversal encouraged long-term contracts. As a result, parties were able to lock-in rates lower than those on the spot market.

Which brings us to the case at hand. During that tumultuous period, Public Utility District No. 1 of Snohomish County Washington (“Snohomish”), one of the largest publically owned utilities in the country, in an effort to reduce its exposure to the high rates, sent out a request for proposals for long-term forward contracts. Snohomish invited Morgan Stanley and 16 others to bid to supply wholesale energy. It received five bids in response—including one from Morgan Stanley. Snohomish rejected Morgan Stanley’s initial bid but requested another bid with different terms. After engaging in lengthy negotiations (in which, notably, both parties were represented by sophisticated counsel), it signed a 9-year contract to buy electricity from Morgan Stanley for $105 per Megawatt hour. These contract prices were much, much lower—about 1/3 the going rate—than Snohomish would have paid in the spot market during the energy crisis when prices peaked at $3,300 per Megawatt hour. During the negotiations, Snohomish had rejected several shorter term offers at higher prices. It wanted the lowest price it could possibly get even if that meant that the contract had to be longer.

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63 Id. at ¶¶ 61,294, 61,980, and 61,982.
64 Morgan Stanley, 554 U.S. at 540.
66 Id.
67 Id. at *11.
68 Morgan Stanley, 554 U.S. at 541.
customers that the contract would provide “a lot of security against the uncertainty of market fluctuations.”

The deal was a very good one for Snohomish—in fact, it did not even distribute all the power it had purchased from Morgan Stanley (and others) to its retail customers instead, it sold some of that power back on the spot market (reportedly making about $17 million in profits from the deal). Of course, when the prices went down below those in the contract, Snohomish no longer wanted to live up to its end of the bargain. Apparently the contracts were no longer “fair” or “reasonable.” This despite a clause in its agreement stating that “[n]othing contained herein shall be construed as affecting in any way the right of the Parties to jointly make application to FERC for a change in the rates . . . .” In other words, if they wanted FERC to change the rate, they had to act together. But Snohomish would simply go it alone because it no longer liked its deal and it asked FERC to modify it.

FERC would have no part of Snohomish’s ploy, saying instead that Snohomish bore the “heavy” burden of overturning the principle of the sanctity of contracts. FERC initially sent the matter to an Administrative Law Judge (“ALJ”), who after a 17-day hearing found that the contract was the product of “bona fide arm’s-length transactions between knowledgeable companies.” FERC agreed with the ALJ and found that the

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70 Id.
71 Id. at *3.
72 Id.
73 Id.
74 Id. at *14 (citing Pet’r’s App. 42a-43a). The contract also stated that the rates were not subject to change under 16 U.S.C. §§ 824d or 824e. Id. (citing Pet’r’s App. 194a).
75 The parties also agreed that the “rates for service specified . . . shall remain in effect for the terms of this Agreement and shall not be subject to change through application to FERC . . . .” Id. at *15 (citing Pet’r’s App. at 194a).
76 Id. at *17.
77 Id. at *18.
Mobile-Sierra presumption applied and that Snohomish had not demonstrated that the contracts threatened the public interest. But Snohomish was undeterred and appealed.

**B. Ninth Circuit Opinion**

The Ninth Circuit granted Snohomish’s petition for review. It decided to limit Mobile–Sierra and imposed layers of agency regulation on private contracts. It said that rates set by contract are presumptively reasonable only where FERC has had an initial opportunity to review the contracts without applying the Mobile-Sierra presumption. The Ninth Circuit also reasoned that to satisfy the just and reasonable requirement under a market-based tariff, FERC must promptly review the terms of the contract after their formation and modify those that do not appear just and reasonable when evaluated without the presumption.⁷⁸ This initial review, according to the Ninth Circuit must include an inquiry into “the market conditions in which the contracts at issue were formed,” and, at least according to the Ninth Circuit, market “dysfunction” is a proper basis for finding a contract not to be just and reasonable.⁷⁹

Despite making its standard up from whole cloth, the Ninth Circuit failed to define what it meant for a market to be dysfunctional. Notably, it didn’t limit that question to misconduct by the parties themselves. What’s more, the Ninth Circuit said the Mobile-Sierra presumption is different for a purchaser trying to show the price is too high versus a seller trying to show that the price is too low. In the case of a buyer complaining about a high price, the Ninth Circuit held they merely need to show that the contract rate exceeds a “zone of reasonableness.”⁸⁰ The Court did not explain why it believed that

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⁷⁸ *Morgan Stanley*, 554 U.S. at 543-44.  
⁷⁹ *Id.*  
⁸⁰ *Public Utility Dist. No. 1 v. FERC*, 471 F.3d 1053, 1089 (9th Cir. 2006).
buyers have a better claim to escaping a bad deal that a seller. The Supreme Court came to the rescue.

**C. Supreme Court Confirms the Importance of the Right to Contract**

The Supreme Court boiled down the case to two questions: (1) whether the *Mobile-Sierra* presumption applies only when FERC has the opportunity to initially review the contract rate without the presumption; and (2) whether challenges by sellers and purchasers are subject to the same standard.

As to the first question, the Supreme Court rejected the Ninth Circuit’s reasoning and instead explained that *Sierra* was based precisely on the idea that sophisticated parties can be expected to negotiate a just and reasonable rate.\(^{81}\) As a result, the *Mobile-Sierra* presumption applies regardless of when the contract is reviewed.\(^{82}\) It is not, as the Ninth Circuit held, “the equivalent of an estoppel doctrine” where an initial review makes a contract rate just and reasonable for ever.\(^{83}\) With regard to the second question, the Supreme Court rejected the Ninth Circuit’s “zone of reasonableness” test and instead held that the standard for a buyer and is the same—the contract rate must seriously harm the public interest to be abrogated.\(^{84}\) Although those are the answers to the specific questions posed, the Supreme Court’s reasoning throughout the opinion is instructive.

For example, the Supreme Court recognized that over the years, FERC had referred to review of contract rates subject to the *Mobile-Sierra* presumption as the “public interest standard” and the review of regular tariffs and the “just and reasonable

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\(^{81}\) *Verizon*, 535 U.S. at 478-479.

\(^{82}\) *Morgan Stanley*, 554 U.S. at 546.

\(^{83}\) In holding that the presumption did not require an opportunity by FERC to review the rate, the Court also found that FERC had flip flopped in its arguments in the lower court. *Id.*

\(^{84}\) *Id.*
standard.” The Supreme Court reasoned that this was merely a matter of semantics and clarified that only one standard exists—that is, whether the rate is just and reasonable—regardless of how it had been referred to in the past. The Court noted that *Sierra*, which plainly distinguishes between unilaterally and bilaterally set rates, held that the only relevant consideration in the case of bilaterally set rates is whether the public interest is harmed. In other words, half a century of precedent could not be ignored: ‘[i]f there were ever a context where long-settled understanding should be honored it is here, when a statutory decision (subject to revision by Congress) has been understood the same way for many years by lower courts, by [the US Supreme Court] by the federal agency the statute governs, and hence surely by the private actors trying to observe the law.”

The Ninth Circuit had also held that FERC must first inquire into whether a contract was formed in an environment of market “dysfunction” before applying the *Mobile-Sierra* presumption. The Supreme Court disagreed. Instead, Justice Scalia said that it would be perverse for contracts to be “less likely to be enforced when there is volatility in the market.” We will discuss this issue again below.

### D. A Brief Interlude for the Dissent

Justice Stevens began his dissent by openly questioning if there is even such a thing as the *Mobile-Sierra* doctrine. He argued that the majority was merely trying to create its own policy—a usurpation of FERC’s rights as a regulator. Justice Stevens specifically took issue with the invocation by the majority of the “important role of

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85 *Id.* at 535.
86 *Id.* at 551.
87 *Id.* at 551, n.6.
88 *Id.* at 547.
contracts in the FPA.”^89 He, joined by Justice Souter, wrote that contracts were only important to the FPA in that they were a departure from a strictly tariff-based regulation scheme.\(^90\) He believed that all rates had to be just-and-reasonable. In reality he actually agrees with the majority. That is because the majority agrees with this premise. The only difference is that the majority recognized that if sophisticated parties enter into a contract setting their own rates, it should be presumptively deemed to be just and reasonable.

Justice Stevens called this a “Pyrrhic” victory for FERC. He said that although they seem to prevail, FERC will now have less discretion in reviewing contract rates under the Mobile-Sierra presumption.\(^91\) But this misses the point. It is contract stability that won, which means FERC, consumers, and democracy won.

6. Analysis

A. Importance of Contract Certainty

Liberty of contract is defined as the ability to determine your own best interests:

> The doctrine that people have the right to bind themselves legally; a judicial concept that contracts are based on mutual agreement and free choice, and thus should not be hampered by external control such as governmental interference. This is the principle that people are able to fashion their relations by private agreements . . . .\(^92\)

In other words, the freedom to contract is the right to enter into agreements with whomever and on whatever condition a person chooses. “It is a presupposition of the whole economic order that promises will be kept. Indeed, the whole matter goes deeper. The social order rests upon stability and predictability of conduct, of which keeping promises is a large item.”\(^93\) Rational actors will enter into contracts that provide the

\(^89\) Id. at 2753.
\(^90\) Id.
\(^91\) Id. at 556-68.
\(^92\) BLACK’S LAW DICTIONARY 689 (8th ed. 2004).
\(^93\) ROSCOE POUND, III JURISPRUDENCE 162-63 (1959).
greatest return and therefore the greatest utility to society. It is thru this free contracting
that society is best able to determine the true cost of goods and allocate them to their best
and highest use. Accordingly, the certainty that contracts provide in the marketplace
provide the best way to allocate resources and lead to the advancement of our society.

This idea is not new. Adam Smith long ago recognized that certainty of contract is
a key to stable economies.94 “When the law does not enforce the performance of
contracts . . . it puts all borrowers nearly upon the same footing with bankrupts.”95 His
contract theory matches his economic theories that the pursuit of self-interest, which he
said was guided by an “invisible hand,” advances societal good.

The founding fathers also long ago understood the importance of the right to
contract. It is a basic right reserved to the people under Article I, Section 10 of the United
States Constitution: “No state shall . . . pass any . . . law impairing the obligation of
contracts.”96 What’s more, the right of individuals to make contracts relating to their
business is a liberty interest protected by the Fourteenth Amendment of the
Constitution.97

In addition to its constitutional roots, contract law encourages “the optimal timing
of economic activity.”98 It also deters “people from behaving opportunistically” toward

94 Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own
interest his own way, and to bring both his industry and capital into competition with those of any other
man, or order of men. The sovereign is completely discharged from a duty, in the attempting to perform
which he must always be exposed to innumerable delusions, and for the proper performance of which no
human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private
people, and of directing it towards the employments most suitable to the interest of the society.
95 ADAM SMITH, THE WEALTH OF NATIONS, Bk I, Ch. IX, at 133 (Edwin Cannan ed., Bantam Dell 2003)
(1776).
96 U.S. CONST. art. I, § 10, cl. 1.
their counterparty.\textsuperscript{99} That concept can only be sustained when parties know that their contracts are going to be enforced.

Thus, there is a critical balancing that must be undertaken between regulation and liberty. Courts have recognized that contract obligations must yield to a proper exercise of the police power. But abrogating a contract that ends up being a bad deal for one of the parties is certainly not the right place to draw the line.\textsuperscript{100}

\textbf{B. Regulation}

We are a nation of capitalists. We believe that with competition come lower prices. We know this first hand when we shop for almost anything available to us. And make no mistake, the Energy Policy Act of 2005 embraced wholesale competition as the national policy of the United States. But we live in an intricate electrical skein that connects our homes, businesses, and hospitals, to massive power plants. Their infrastructure runs through our cities and town and must therefore be safe. We want safe and reliable service but we want it without discouraging participation and investment. Some regulation is called for. But how much?

Adam Smith, father of modern economic theory and champion of laissez-faire, recognized that as free markets became more complex, certain incongruities must be corrected.\textsuperscript{101} Smith believed that markets had to be fair to work properly. So even under Adam Smith’s laissez-faire regime, regulation has a role to play to ensure properly functioning markets.

Friedrich A. Hayek also believed that economic planning by the government would reduce competition, eliminate the pricing system, and lead to “serfdom.” Although

\textsuperscript{99} \textit{Id.}
\textsuperscript{100} \textit{Triegle v. Acme Homestead Ass’n}, 297 U.S. 189, 197, 56 S. Ct. 408, 411 (1936).
\textsuperscript{101} See Smith, supra note 95.
Hayek was mainly concerned with government planning, it is not a huge leap to compare central planning with the creep of government regulation. Regulation, like planning, is not the optimal way to foster competition in a market economy. Hayek does, however, like Smith, find a place for some regulation:

Any attempt to control prices or quantities of particular commodities deprives competition of its power of bringing about an effective coordination of individual efforts, because price changes then cease to register all relevant changes in circumstances and no longer provide a reliable guide for the individuals actions. . . . This is not necessarily true, however, of measures merely restricting the allowed methods of production, so long as these restrictions affect all potential producers equally and are not used as an indirect way of controlling price and quantities. . . . To prohibit the use if certain poisonous substances or to require special precautions in their use, to limit working hours, or require certain sanitary arrangements, is fully compatible with the preservation of competition.

According to Hayek regulation and competition can be compatible, but competition is preferred.

But regulation is a tough nut to crack. This is because it would be difficult to argue, as Smith and Hayek would agree, that everything should be completely deregulated. Some regulation is required. By free markets, Smith and Hayek mean free of unnecessary government interference, not completely unregulated. Thus, regulators should encourage competition whenever possible, minimize the costs of information asymmetry, and encourage a transparent market. But it is the apothecary that must find the proper mix of freedom of contract and government regulation.

C. Importance of Forward Markets
The beauty of forward markets is that we get the certainty of fixed prices at some time in the future.\textsuperscript{102} The party agreeing to buy the underlying asset in the future assumes a “long” position, and the party agreeing to sell the asset in the future assumes a “short” position. The price agreed upon is called the delivery price, which is equal to the forward price at the time the contract is entered into. It is a way to hedge market risk.

For over 50 years this Court has recognized how important enforcing contracts has been to the energy-futures market. The need to manage risk in these markets is especially important because the spot markets for energy are inherently volatile. This is because as opposed to other types of commodities, electricity cannot be stored in large quantities. When you can’t store something, if demand spikes, there is no inventory to meet it. The energy crisis in California is an example of that type of volatility. The risk for great price movement causes substantial risk for buyers and sellers making forward contracts an important tool to hedge that risk.

Stable and enforceable contracts are important in any market, but the market for electric power is a unique animal. It requires huge sums of money to develop infrastructure and that money may take a long time to recoup. This is in part a result of boom and bust cycles that characterize the industry. And the United States faces massive growth in its demand for electricity.\textsuperscript{103} Accordingly, significant energy investment is going to be needed to meet the ever growing demand for power. Why would anyone invest the vast sums of money required if they don’t know if they will ever get a return on their investment? They wouldn’t. And FERC agrees: “[c]ompetitive power market s

\textsuperscript{102} Futures markets are similar but different than forwards. Futures markets are organized markets that trade standardized contracts representing something that will happen at a future date. The Chicago Mercantile Exchange is probably the most important futures market in the world.

simply cannot attract the capital needed to build adequate generating infrastructure without regulatory certainty, including certainty that [FERC] will not modify market-based contracts unless there are extraordinary circumstances.**104**

Forward contracts also help create a stream of payments that give investors some assurance that they will recover their sunk costs. They may be able to also get asset-based loans on these contracts permitting them to stay competitive. This will encourage participation and will avoid a monopolistic energy supply. Getting to the proper level of infrastructure will also help reduce the threat of future crisis. Forward contracts are therefore critical to encourage long-term investment in the energy markets.

But forward markets don’t work if the parties don’t know if the contract is going to be enforced. It is not uncommon for markets to change and the deal to sour for one of the parties. But that’s the point. Unless you know that when conditions change the contract will still be enforced the contract is really a nullity to begin with and no one will enter into them. And then this valuable risk-reducing tool will be forever lost.

The need for certainty is even more important in a market-based tariff regime. In a cost-based environment, suppliers don’t have much of an incentive to reduce costs. Therefore they may create too much supply. Market-based tariffs reduce those inefficiencies and create the proper incentives. But an unintended result is that lees excess supply will exist in times of need. Forward contracts help solve that problem because utilities will know that they at least have part of their needs met by these long-term deals.

During the crisis, utilities were killed every which way because they had to buy

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electricity at much higher prices than they could sell it at because of rate caps. This could have been mitigated by long-term contracts.

Certainty in forward markets is especially important given the advent of power marketers with market-rate authority. The power marketers help create an efficient market for wholesale power. Power marketers allow parties to create a diverse portfolio of forward contracts that insulate them from price volatility. For example, a trader can sell power to a distributor at a price certain. The utility gets certainty and the trader can mitigate its risk by extensive trading. Traders are both sellers and buyers—they simply look for the best price. This creates an efficient market with liquidity—that is, distributors find supply and producers find buyers. This benefits the very consumers whom the statute was designed to help in the first place by encouraging efficient production and distribution of electric power.

B. Buyers Remorse

Parties to long-term contracts are always negotiating in the face of uncertainty. There is never complete information—the theory of efficient markets notwithstanding. Long-term contracts are the best way to ameliorate this problem. A seller takes the risk that prices will increase and the buyer takes the risk that process will decrease. As time passes, one side wins and the other loses. But this doesn’t mean that the price was unjust or unreasonable. On the contrary, the entire point of forward contracts is to set a price that everyone lives with despite the fact that price fluctuations may occur.

What makes the courts and FERC think that they are better positioned than two sophisticated parties in an arms-length deal to come up with a fair price? They aren’t. The parties to the contracts make these types of decisions every day. They know how to read
markets because they operate in the trenches every day. In fact, the Supreme Court recognized this when it said that sophisticated businesses enjoying presumptively equal bargaining power are able to negotiate a just and reasonable rate.\(^\text{105}\) It is not economically reasonable to create a system where years after the contract was entered into, courts and regulators try to recreate the all of the nuanced reasons to enter into the contract into the first place. Both parties concluded that the contract was in their best interest and that must be honored.

In fact, the guru of law and economics, Judge Posner, has said that “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, and the assignment of the latter risk to the buyer is even clearer where, as in this case, the contract places a floor under price but allows for escalation. If, as is also the case here, the buyer forecasts the market incorrectly and therefore finds himself locked into a disadvantageous contract, he has only himself to blame and so cannot shift the risk back to the seller by invoking impossibility or related doctrines.”\(^\text{106}\)

\section{C. The Mobile-Sierra Doctrine Should Apply Even if the Contract is Negotiated in the Context of a Dysfunctional-Power Market}

\subsection*{(1) Markets are Not Perfect}

There were no surprises here. Everyone knew that the markets were chaotic. That was the very reason that Morgan Stanley and Snohomish entered into the forward contract in the first place—mitigation of risk. As discussed above, Snohomish even resold some of the energy and made a profit. But now things have changes and Snohomish no longer likes the deal. Well that’s just too bad.

\(^{105}\) \textit{Verizon}, 535 U.S. at 479.
\(^{106}\) \textit{N. Ind. Pub. Serv. Co. v. Carbon County Coal Co.}, 799 F.2d 265, 278 (7th Cir. 1986) (Posner, J.)
A volatile market can have extreme fluctuations. It is precisely because markets are not perfect that parties decide among themselves how to allocate risk.\textsuperscript{107} It is to be expected for prices to go up and down in a normal market. This is a rational response to increases or decreases in supply and demand, etc. We want the market to react to these conditions. Preventing those market forces—that is, Adam Smith’s invisible hand—to properly function would cause real market dysfunction.

The need to reduce risk is arguably most needed when a market is facing its most volatile conditions. If one of the parties can revisit the contract when things go badly for it, the entire market would question whether this is really a viable way to hedge risk. Thus, they would lose the ability to hedge when they need it most.

We also need to create the proper incentives. Forward contracts encourage stability. They allow utilities to manage risk. Therefore, courts and regulators need to do everything possible to encourage forward contracts in periods of volatility. Courts ought not make those contracts a mere guessing game. It is markets and not courts or regulators that we should count on to establish “just and reasonable” rates. In fact, it gave Snohomish stability in its energy costs for some time.

Energy suppliers should not bear the risk that a freely negotiated contract will be declared unjust and unreasonable simply because FERC thinks the price is too high. If the supplier bears that risk, it will deter suppliers from entering into long-term contracts to supply consumers with the power supply that they need.

(1) Markets are Often Dysfunctional

\textsuperscript{107} Morgan Stanley, 554 U.S. at 547. (“. . . one of the reasons that parties enter into wholesale-power contracts is precisely to hedge against the volatility that market imperfections produce.”).
Market “dysfunction” is not a good reason to abrogate forward contracts. First, what does that even mean? Does it include the weather? The California regulatory regime? Anything else? Fluctuations that look random are often only a rational response to publically-available information. Making this a guessing game for parties would lead to great uncertainty and litigation if we replace the Mobile-Sierra doctrine with vague and unpredictable rules.

And while we are asking questions, what is the market? Is it the spot market, the forward market, or both? This is not a simple question and one the court grappled with.

Justice Scalia: I don’t understand what that means, anyway. The current dysfunction carried over into . . . into the future market? What does that mean?

Does it mean that because of the current dysfunction, you can’t predict for sure what the rates are going to be down the road? Of course it means that. But doesn’t a dysfunction always mean that?

And isn’t that why you enter into long-term contracts?

Because given the current dysfunction you have no idea what the price is going to be down the road.

It is precisely because of the uncertainty in the spot market prices, which inherently includes any dysfunction, that parties enter into forward contracts. Contract certainty should not be set aside just because it turns out there was more going on than we knew. That is the entire point of forward contracts. We cannot allow an economic Catch 22—that is, you can only enter into a long-term forward contract if there is no market dysfunction, but you especially need a long-term forward contract when there is market dysfunction.

What’s more, if you let buyers escape contracts during periods of market dysfunction, sellers would ultimately have to charge more to cover the additional risk of
whether or not the contract will be enforced. This would inevitably lead to higher costs for consumers. Precisely what the statute is trying to avoid. We need to make it policy that these contracts will be honored. We are the backbone of the world economy and much of that is thanks to our unwavering commitment to the right to contract. That right must be preserved.

**E. Contracts Should not be Abrogated Unless one of the Contracting Parties is Guilty of Misconduct**

Sometimes you will find people that try to manipulate the markets for their benefit. But if the parties to the contract are not involved, there is no reason to abrogate the contract. In fact, forward contracts help to solve this very problem by making the spot market more competitive. If parties are bound by long-term contracts, it becomes more difficult to manipulate the market. And given that they encourage investment, it increases the supply. By increasing supply, it becomes more difficult for any one entity to engage in anti-competitive conduct.

On the other hand, if you punish the parties entering into stabilizing long-term contract based on the behavior of a non-party to the agreement, you are creating the wrong incentives. How can a party be expected to decline to enter into a forward contract because some mystery bad actor out there somewhere might be influencing prices? How could they determine if that is “dysfunction” that a court or agency would find? They can’t. So you would be left with more volatility and higher prices for consumers—exactly what we say that we don’t want. It is also possible that both parties may have known about purported market manipulation. Let the contract stand.

**F. Contracts Should Only be Abrogated if the Parties’ Misconduct Involved the Forward Contract Itself**
Even Adam Smith would likely agree that if a party commits some bad act that affects the price of the forward contract, the counterparty should be relieved from performing. But this is a very high standard. It is very difficult to affect the long-term electricity market. In the case of storable commodities, there is a nexus between the spot price and the forward price because of arbitrage opportunities. But, as already mentioned before, electricity is not storable in any practical way. Thus, the spot-market is a separate market. Because of the separate nature of the markets, manipulation in one will not have an impact on the other as it might with other commodities. So an allegation of manipulation of the spot markets is not enough.

What’s more, the parties already have regular contract defenses available to them. And it gives the parties fair notice. If you are a fraudster, you don’t have an expectation that your contract will be upheld. You also are in the best position to know that and therefore should bear that risk.

G. Whether it is the Seller or Purchaser Complaining Does Not Make a Difference

Life is not a one-way street. The Supreme Court rejected the Ninth Circuit’s holding that even when the presumption applies, courts should rewrite the parties agreement if a rate was higher that what one would see in a “zone of reasonableness.” This cannot be the law. Because forward contracts are about risk allocation, the standard must be the same for seller or buyer—it must harm the public interest. It should not place a buyer’s sour grapes over a seller’s.
The FPA regulatory scheme was designed to “preserve the ‘integrity’ of private contractual arrangements.”

The intent of Congress was not to favor one party over the other but to instead show “its concern for the legitimate interests of the companies in whose financial stability the . . . consuming public has a vital stake.”

**H. Philosophy**

Snohomish sent out an RFP. It rejected Morgan Stanley’s initial bid. They proceeded to negotiate for over a week—including calls, and exchanging drafts. The negotiations were very detailed until the agreement was reached. Snohomish itself admitted that its long-term contracts with Morgan Stanley and others gave them “a lot of security against the uncertainty of market fluctuations.”

Arms length agreements between sophisticated parties should be presumed just and reasonable. There is nothing wrong with trying to make a profit. This point was driven home by an exchange between Christopher J. Wright, attorney for the Respondents, and Justice Scalia:

Mr. Wright: [T]here is every reason to think that Morgan Stanley doesn’t have the sort of claim that they have suggested . . . . There is every reason to think that they bought power before the big spike came, and that they bought power since then, and that they’re not . . . they’re not buying power at 104 and selling at 105 . . . .

Justice Scalia: Well good for them. [Laughter] I mean you’re suggesting they should be punished for that? I don’t understand what . . . what follows?

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109 Id.
111 Id. (citing Pet’r’s App. at 165a).
112 Id.
113 Id.
H. Implications

(1) No Uncertainty About the Applicability of the Presumption

The Court’s decision confirmed that arms-length, long-term agreements must be honored. These contracts will be upheld absent a violation of the public interest. The presumption will also apply regardless of which party challenges the rate. Thus, parties will be certain about the validity of their contract and this will encourage investment and bring stability to electricity markets.

(2) Still Administrative Authority for FERC

The Court reasoned that the Mobile-Sierra presumption will not apply where the “dysfunctional” market conditions were caused by one party to the agreement: “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, [FERC] should not presume that the contract is just and reasonable.”115 Because this will be by definition a highly fact-specific analysis, FERC will still retain discretion and power. What’s more, there has to be a causal connection between the conduct and the contract rate—which has expensive expert testimony written all over it.

What will this mean? How does one party alter the market? A starting point is FERC’s own statement that “analysis of a generic link between the dysfunctional spot market and the forwards markets is not adequate to establish a causal connection between a particular seller’s alleged unlawful activities and the specific contract negotiations.”116

7. Conclusion

115 Morgan Stanley, 554 U.S. at 547-52.
We need competition for a successful economy. It is the best way to organize the allocation of resources. Nevertheless, successful competition requires some regulation.

We all agree that we need certain social services and basis infrastructure. We also can not allow corporations to destroy our environment. But just because some regulation is necessary does not mean that we should regulate when there is no need. We need to regulate to facilitate competition not to stifle it. And when parties are able to negotiate an agreement that they believe is fair, it should be enforced. The right to contract must, and now assuredly does, live on.