The Federal Energy Regulatory Commission's Authority to Amend Rate Agreements: The *Snohomish County* Decision

-name redacted-
Legislative Attorney

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Summary

In June of 2008, the U.S. Supreme Court issued a decision that has important implications for the authority of the Federal Energy Regulatory Commission (FERC) to review wholesale electricity and natural gas contracts under what is known as the "*Mobile-Sierra* Doctrine." The Doctrine mandates that FERC will not abrogate contracts (including wholesale natural gas and power contracts as well as transmission agreements) between private parties absent a showing that a change is necessary in the public interest. This report reviews the *Mobile-Sierra* Doctrine and discusses a recent Supreme Court decision that evaluated the Doctrine and FERC's review role as set forth in the Federal Power Act in the context of market-based rates.

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Background

In June of 2008, the Supreme Court issued its decision in *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1 of Snohomish County*.[1] In this decision, the Court evaluated the authority of the Federal Energy Regulatory Commission (FERC) to amend wholesale electricity agreements pursuant to the *Mobile-Sierra* Doctrine. The decision has wide-reaching implications for FERC's authority under the Federal Power Act (FPA), and, by extension, its authority under the Natural Gas Act (NGA). These two statutes form the basis of FERC's regulatory authority.

The federal government regulates wholesale sales of electricity and transmission of electricity and natural gas under the FPA and the NGA. These two statutes charge FERC with a number of oversight responsibilities.[2] One of these responsibilities is the review of contracts between electricity and natural gas companies and their wholesale or interstate customers in order to confirm that the rates charged by these electricity and natural gas companies for power and gas are "just and reasonable."[3]

For many years, FERC evaluated these contracts in an environment of "cost-based" rates; that is, rate approval was based on the actual cost of service, which includes costs associated with generating or purchasing the electricity or natural gas on the wholesale market as well as transportation and other costs, plus a rate of return. Thus, a FERC review of contracts was conducted with an eye toward ensuring that the wholesale customers were paying just and reasonable rates based on the costs incurred by the seller. However, in recent years some regulatory authorities have experimented with "market-based" rates for electricity, in which pricing is determined not by actual cost of service, but by market forces. This shift was initiated by passage of the Energy Policy Act of 1992,[4] which created the basic framework for a competitive wholesale electricity market. This has altered FERC's regulatory role to some degree. Some have wondered how certain fundamental doctrines of FERC rate review would apply in the context of market-based rates. One such FERC doctrine is the *Mobile-Sierra* Doctrine.

What is the *Mobile-Sierra* Doctrine?

The *Mobile-Sierra* Doctrine has been a foundation of FERC regulatory behavior since the Supreme Court decisions were handed down in 1956. The Doctrine articulates the extent of FERC's authority to amend rate agreements. In two concurrent decisions issued in 1956, the U.S. Supreme Court interpreted FERC's authority under the FPA and the NGA with respect to contracts, and limited FERC's authority in situations where the parties seek to reform contracts that FERC had previously approved. In these cases, *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp*.[5] and *FPC v. Sierra Pacific Power Co*.,[6] the Court held that an electricity or natural gas

[1] 128 S. Ct. 2733 (2008).

[2] The Federal Power Commission (FPC) was the predecessor to FERC and was responsible for administration of the FPA and NGA, a responsibility that now is FERC's. For purposes of clarity and continuity, this Report will refer to actions of both the FPC and FERC as FERC activity.

[3] NGA, 15 U.S.C. §§ 717c and 717d, FPA, 16 U.S.C. § 824d. Regulation of electricity and natural gas sales at the retail level are handled by the state public utility commissions.

[4] P.L. 102-486.

[5] 350 U.S. 332 (1956).

contract, once approved by FERC, cannot be changed pursuant to a unilateral request of one of the parties absent a showing that such a change is in the public interest. This rule has become known as the *Mobile-Sierra* Doctrine.

Under both the FPA and the NGA, FERC has substantial authority to amend the terms of an agreement prior to its becoming effective, and may amend it to ensure that the rates charged are "just and reasonable." However, once FERC has approved a rate agreement, a presumption of validity (sometimes called the *Mobile-Sierra* presumption) is created, and the agreement cannot be amended absent a showing that the change is in the public interest. Thus, the Supreme Court stated that a rate for electric power that had become unprofitable since formation of a long-term agreement could not be changed unless the utility could show that the rate was "so low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory."[7] This has become the FERC standard for determining whether a rate is in the public interest.

Evolution of the *Mobile-Sierra* Doctrine

The *Mobile-Sierra* Doctrine was strictly enforced for many years after it was first articulated by the Court.[8] In the early 1980s, the courts began to articulate the Doctrine in a way that gave FERC more leeway to make changes to approved contracts. A series of decisions found that in certain situations, FERC has authority to amend a rate agreement upon a showing that amendment is needed in order to ensure "just and reasonable" rates.

In *Papago Tribal Util. Auth. v. FERC* (*Papago II*),[9] the U.S. Court of Appeals for the District of Columbia Circuit considered a utility's petition to adjust rates pursuant to Section 206 of the FPA, which authorizes FERC to correct rates on its own motion or upon complaint whenever it finds them to be "unjust, unreasonable, unduly discriminatory or preferential."[10] This authority differs from Section 205 of the FPA and its accompanying regulations, which require utilities to charge just and reasonable rates and authorizes utilities unilaterally to file for changes in such rate schedules as necessitated by changes in costs.[11] In *Papago I*, the court had held that the rate contract in question had contractually eliminated the utilities' option to petition FERC for rate changes pursuant to Section 205, and thus, pursuant to the *Mobile-Sierra* Doctrine, the rate could not be altered absent a showing that such a change was in the public interest. However, the utility subsequently filed a Section 206 complaint. The court held that although the *Mobile-Sierra* Doctrine barred Section 205 changes to the negotiated rates absent a showing that such a change

(...continued)

6 350 U.S. 348 (1956).

7 Sierra, 350 U.S. at 355.

8 *See, e.g.*, *Richmond Power & Light v. FPC,* 481 F.2d 490 (D.C. Cir. 1973) (holding that the Doctrine is applicable to contracts on file with state regulatory agencies that tied the utility's wholesale rate to the retail industrial rate, thus expanding the Doctrine beyond "fixed" rates to cases where the rates are subject to change in a certain manner); *Papago Tribal Util. Auth. v. FERC*, 610 F.2d 1979 (D.C. Cir. 1979) (*Papago I*) (holding that the Doctrine was applicable to contracts that allow the utility to seek rate increases pursuant to section 205 of the FPA).

9 723 F.2d 950, 954 (D.C. Cir. 1983).

10 16 U.S.C. § 824e. The act does not further define "unjust, unreasonable, unduly discriminatory or preferential."

11 The *Sierra* decision was based on an appeal of a FERC determination under Section 205 of the FPA.

was in the public interest, it did not, in this instance, bar a Section 206 challenge to the rate agreement.[12] Therefore, FERC could properly evaluate a proposed rate change under the less stringent "just and reasonable" standard rather than the "public interest" standard of the *Mobile-Sierra* Doctrine. The court noted that "[t]he public-interest standard is practically insurmountable; [FERC] itself is unaware of any case granting relief under it,"[13] and thus the "just and reasonable" test provided a less restrictive standard.

Similarly, a second decision issued by the U.S. Court of Appeals for the District of Columbia Circuit on the same day as *Papago II* also held that the *Mobile-Sierra* Doctrine was inapplicable to another type of rate dispute. In *Kansas Cities v. FERC*,[14] the court held that, under certain circumstances, rate contracts containing "regulatory approval clauses," or RACs, could be amended by FERC under the "just and reasonable" standard rather than the stricter "public interest" standard applied under the *Mobile-Sierra* Doctrine. RACs come in a variety of types, but they generally provide that the rates in the contracts are subject to regulatory approval. Although the *Mobile-Sierra* Doctrine had previously been held applicable to such contracts, in this case the court found that the rates could be reviewed under the less stringent "just and reasonable" standard.[15] However, the court seemed to take care to narrow the scope of its ruling, noting that it applied only to the fact pattern presented in the case.[16]

Subsequently, a series of decisions related to Northeast Utilities Service Company in the early 1990s suggested further erosion of the once strict application of the *Mobile-Sierra* Doctrine. The contract at issue in this dispute explicitly incorporated the Doctrine by stating that the rate could not be changed unless FERC found that the rate was contrary to the public interest. Nevertheless, FERC initially applied the "just and reasonable" standard in disapproving one aspect of the rate filing.[17] The U.S. Court of Appeals for the First Circuit rejected this holding, finding that FERC should have applied the *Mobile-Sierra* "public interest" standard as dictated by the contract.[18] On remand, FERC applied the *Mobile-Sierra* Doctrine as directed by the court, but stated that "the 'public interest' standard of review under the *Mobile-Sierra* Doctrine could not be 'practically insurmountable,'" and that "a more flexible standard is therefore appropriate."[19] Pursuant to this line of reasoning, FERC revised the contracts "in the public interest," setting forth a long list of relevant factors to be considered in determining whether a contract reformation was "in the public interest," including whether the contract had previously been reviewed by the Commission and made public, whether the contract truly reflects the intent of the parties, and what impacts the contract might have on third parties.[20] The United States Court of Appeals for the First Circuit upheld FERC's broad interpretation of the *Mobile-Sierra* "public interest" standard in this instance, noting, as FERC did, the importance of protecting third parties.[21]

[12] Papago II, 723 F.2d at 954.

[13] Id.

[14] 723 F.2d 82 (D.C. Cir. 1983).

[15] Id. at 96.

[16] Id. at 88, 90.

[17] *Northeast Util. Serv. Co.*, 53 F.E.R.C. ¶ 63,020 (1990).

[18] *Northeast Util. Serv. Co. v. F.E.R.C.*, 993 F.2d 937, 962 (1st Cir. 1993).

[19] *Northeast Util. Serv. Co.*, 66 FERC ¶ 61,332 at 62,076 (1994).

[20] Id. at 62,087-88.

[21] *Northeast Util. Serv. Co. v. FERC*, 55 F.3d 686, 691 (1st Cir. 1994).

The Doctrine in the Market-Based Rate Environment: FERC and Circuit Court Decisions in the *Snohomish* Matter

As described above, FERC's application of the *Mobile-Sierra* Doctrine has evolved and some commentators might suggest that the Doctrine has become a less significant hurdle to FERC review/amendment of rate agreements in recent years. An interesting twist on the application of the Doctrine came about with the introduction of market-based wholesale rates in the late 1990s. Traditionally, utilities had charged "cost-based" rates, in which customers paid rates that corresponded roughly to the charges incurred by the utilities in providing services. The *Mobile-Sierra* Doctrine was generally applied to disputes over contracts for long-term wholesale power service where a change had occurred since the signing of the agreement, for example, if costs had shifted dramatically since the parties signed the agreement. However, in the late 1990s FERC started to permit utilities to charge market-based rates to customers upon a showing of a sufficiently competitive market to ensure that the utility could not abuse its market position. A utility charging market-based rates would charge the rate that the market would bear, rather than the traditional cost-based rate.

The applicability of the *Mobile-Sierra* Doctrine to contractual rate agreements in the context of a market-based rate environment was put to the test in a series of decisions involving several power purchase contracts. These agreements were formed in the wake of a severe spike in electricity prices on the spot market in California in late 2000 and early 2001.[22] In response to this extraordinary price shift, a number of utilities and other wholesale power customers (including Snohomish County) made long-term power purchase deals to afford them rate stability. In each case, the wholesale customers paid prices for electricity that were well in excess of the prices available elsewhere during the terms of their deals, and they were unable to convince state regulatory agencies to allow them to recoup their losses at the retail level.

These wholesale customers petitioned FERC to change their contract price terms pursuant to Section 206 of the FPA. The customers felt that the contracts should not be presumed to be just and reasonable under the *Mobile-Sierra* Doctrine because they had not been initially approved by the Commission upon formation. The customers also argued that they were entitled to contract modification because the high prices in the contract were a product of extraordinary circumstances that they could not have predicted, caused at least in part by collusion and market manipulation, and were not in the public interest.

FERC rejected the wholesale customers' argument and found that the contracts formed in a FERC-authorized market-based rate environment were entitled to a presumption of validity under the *Mobile-Sierra* Doctrine, even if the individual contracts were not reviewed prior to formation.[23] FERC also rejected the customers' claim that the contracts should be amended under the *Mobile-Sierra* Doctrine because the rates were so high that they violated the public interest,

[22] This price spike was associated with the highly publicized California electricity crisis.

[23] *Nevada Power Co. and Sierra Pacific Power Co. v. Enron Power Marketing*, Order on Initial Decision, 103 FERC ¶ 61,353 (2003). This decision affirmed the findings of a FERC Administrative Law Judge. 101 FERC ¶ 63,031 (2002). FERC later affirmed its decision in an Order on Request for Rehearing and Clarification. 105 FERC ¶ 61,980 (2003).

noting that "[t]he fact that a contract becomes uneconomic over time does not render it contrary to the public interest."[24]

The wholesale customers appealed FERC's decision to the U.S. Court of Appeals for the Ninth Circuit. In its decision on this matter, the court seemed to tread new ground in the application of the *Mobile-Sierra* Doctrine. The court found that "[w]hile there is language in some cases suggesting otherwise, we are convinced that *Mobile-Sierra* establishes one means of review under the just and reasonable standard, applicable in certain limited circumstances."[25] The court found that rather than establishing a stricter "public interest" standard for review of certain contracts, the *Mobile-Sierra* Doctrine simply establishes that "consideration as to what is 'unjust' or 'unreasonable' differ in the context of an established bilateral contract, not that the statutory standards no longer govern."[26] In a market-based rate environment, the court stated that contracts are presumptively reasonable only if FERC has had an initial opportunity to review them promptly after they are formed.[27] The court also held that when a power purchaser challenges a contract that is entitled to a presumption of reasonableness under the *Mobile-Sierra* Doctrine, FERC should review the contract to determine whether the rate exceeds what the court called the "zone of reasonableness."[28] Based on these findings, the court held that the requirements for application of the *Mobile-Sierra* Doctrine presumption of contractual validity were not in place when the contracts in question were formed, and that FERC therefore was in error in applying this presumption in its review of these contracts. The Ninth Circuit remanded its decision to FERC for evaluation of the agreements in accordance with its ruling.

Reining in FERC's Application of the Doctrine: The Supreme Court Decision in *Snohomish*

The sellers petitioned the Supreme Court to review the Ninth Circuit's decision. The Court granted certiorari, heard arguments on February 19, 2008, and issued its decision on June 26, 2008. The Court upheld the Ninth Circuit's remand of the contracts to FERC for further review, but disagreed with the lower court's rationale and its application of the *Mobile-Sierra* Doctrine.

The Court agreed with the Ninth Circuit that the only standard that should guide FERC review of contracts is to ensure that they are "just and reasonable," as required by the FPA.[29] However, the Court disagreed with the Ninth Circuit's statement that the *Mobile-Sierra* Doctrine requires FERC to review contracts upon their formation to determine whether they are "just and reasonable." Instead, the Court found that the Doctrine:

> was grounded in the commonsense notion that "[i]n wholesale markets, the party charging the rate and the party charged [are] often sophisticated businesses enjoying presumptively

[24] Id. at 62,384 (2003). This decision affirmed the findings of a FERC Administrative Law Judge. 101 FERC ¶ 63,031 (2002). FERC later affirmed its decision in an Order on Request for Rehearing and Clarification. 105 FERC ¶ 61,980 (2003).

[25] *Snohomish*, 471 F.3d at 1074 (citations omitted).

[26] Id. at 1075.

[27] Id. at 1079-85.

[28] Id. at 1088-90.

[29] *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1 of Snohomish County*, 128 S. Ct. 2733 (2008).

> equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them." Therefore, only when the mutually agreed-upon contract rate seriously harms the consuming public may the Commission declare it not to be just and reasonable.[30]

The Court further stated that FERC did not need to address the possibility of a "dysfunctional" market before it granted a *Mobile-Sierra* presumption of justness and reasonableness to a market-based rate contract.[31] The Court noted that market imperfection is one of the reasons that parties enter into long-term contracts, and therefore it would be a "perverse rule" if it were more difficult to enforce long-term contracts formed in volatile markets.[32]

The Court also took issue with the Ninth Circuit's assertion that FERC should employ a "zone of reasonableness" test to evaluate a buyer's claim that a contract rate is not just and reasonable, characterizing it as "overarching."[33] The Court stated that there should not be a distinction between power contract challenges brought by buyers and those brought by sellers. In both cases, the Court held, the proper test is whether the contract rate in question "seriously harms the public interest."[34] The Court stated:

> A presumption of validity that disappears when the rate is above a marginal rate is not presumption of validity at all, but a reinstitution of cost-based rather than contract-based regulation. We have said that, under the *Mobile-Sierra* presumption, setting aside a contract rate requires a finding of "unequivocal public necessity," or "extraordinary circumstances." In no way can these descriptions be thought to refer to the mere exceeding of marginal cost.[35]

Despite these rejections of the Ninth Circuit's reasoning, the Court agreed with the Ninth Circuit's decision to remand the decision to FERC. The Court was critical of FERC's analysis of the customer's petition to amend the rates. The Court noted that FERC appeared to have looked solely at the rates paid by consumers immediately after the contracts in question went into effect, instead of determining whether consumers bore an excessive burden at any later point.[36] The Court was critical of FERC in this respect, noting that "[t]he 'unequivocal public necessity' that justifies overriding the *Mobile-Sierra* presumption does not disappear as a factor once the contract enters into force."[37]

The Court thus set forth what could be considered a stricter standard that must be met before FERC will adjust rates, noting that contracts should not be adjusted or set aside absent "unequivocal public necessity" or "extraordinary circumstances." The Ninth Circuit's "zone of reasonableness" test could have been interpreted as greatly extending FERC's authority to adjust rate contracts pursuant to the *Mobile-Sierra* Doctrine. The Court's decision appears to rein in any such extension of authority.

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[30] Id. at 2746 (quoting *Verizon Communications, Inc. v. F.E.R.*C., 535 U.S. 467, 479 (2002).

[31] Id.

[32] Id.

[33] Id. at 2748.

[34] Id. at 2737.

[35] Id. at 2748-49.

[36] Id. at 2749-50.

[37] Id. at 2750.

The Court also took issue with FERC's dismissal of the relevance of its own findings that some of the power sellers in question had engaged in market manipulation. The buyers had argued that their contracts were entered into as a way to hedge against high prices on the open market, and that these high prices were the result of market manipulation. FERC had dismissed this argument despite a FERC Staff Report that had concluded that abnormally high open market prices during the relevant time frame had influenced the terms of power purchase contracts. The Court found that, given the conclusion of the Staff Report, FERC had erred in presuming the contracts were "just and reasonable."

As of the date of this report, FERC has not taken further action on this matter.

Author Contact Information

(name redacted)
Legislative Attorney
[redacted]@crs.loc.gov, 7-....