Does the Mobile-Sierra Doctrine Apply When a Contract is Challenged by a Noncontracting Third Party?

Jay E. Grenig
Marquette University Law School, jay.grenig@marquette.edu

Publication Information
Jay E. Grenig, Does the Mobile-Sierra Doctrine Apply When a Contract is Challenged by a Noncontracting Third Party?, 37 Preview U.S. Sup. Ct. Cas. 112 (2009).

Does the *Mobile-Sierra* Doctrine Apply When a Contract Is Challenged By a Noncontracting Third Party?

CASE AT A GLANCE

The Federal Power Act requires that the rates for the transmission and sale of electricity in interstate commerce be just and reasonable. Under the *Mobile-Sierra* doctrine, the Federal Energy Regulatory Commission (FERC) must presume that rates set in freely negotiated wholesale-energy contracts meet the just and reasonable requirement. This presumption may be overcome only if the FERC concludes that the contract seriously harms the public interest. The Court is now asked whether the doctrine is inapplicable when a noncontracting third party challenges the rate.

NRG Power Marketing, LLC, et al. v. Maine Public Utilities Commission et al.
Docket No. 08-674

Argument Date: November 3, 2009
From: The Seventh Circuit

by Jay E. Grenig
Marquette University Law School

ISSUE

Is the *Mobile-Sierra* doctrine—which prohibits the Federal Energy Regulatory Commission (FERC) from modifying or abrogating electricity and natural gas contracts unless they are shown to be contrary to the public interest—inapplicable when a contract is challenged by a non-contracting third party?

FACTS

In order to understand the lead-up to the current issues before the Court, it is first necessary to learn a little bit about the electricity industry. In this context, the term *capacity* refers to the ability to produce electricity as opposed to electricity itself. Utilities purchase capacity from generators to ensure that the system has adequate electricity resources to meet demand at all times, averting blackouts or other reliability problems. A utility that purchases capacity is essentially paying to ensure that electricity is available whether or not that electricity is ultimately used.

In a capacity market—as opposed to a wholesale electricity market—the transmission provider (the entity that is purchasing the capacity) compensates the generator for the option of buying a specified quantity of power irrespective of whether it ultimately buys the electricity. In order to maintain the reliability of the grid, transmission providers generally purchase more capacity than is necessary to meet their customers' demand for electricity. This ensures that the transmission providers are able to respond adequately to unexpected fluctuations in demand.

New England's electric utilities have long integrated their transmission systems so that capacity in one area can be used to meet demand elsewhere. In 1998, the utilities created an independent entity—ISO New England—to manage those systems. An independent system operator is an independent company having operational control, but not ownership, of the transmission facilities owned by member utilities.

For many years, New England's capacity market has had numerous problems. In 2003, the Federal Energy Regulatory Commission noted that the supply of capacity was barely sufficient to meet New England's energy demand. The FERC, the generators, the transmission providers, and the power customers have made several attempts to address these issues. In 2003, a group of generators sought to enter into "Reliability Must-Run" agreements with the ISO-New England. Under a Must-Run agreement, a financially troubled generator in an area with supply shortages may recover up to its full cost-of-service in order to remain in operation.

The FERC accepted the Must-Run agreements filed by the New England generators but only allowed those generators to recover certain maintenance costs, not their full cost-of-service. In its orders addressing the Must-Run agreements, the FERC simultaneously directed the ISO-New England to develop a new market mechanism that would include a location requirement. Such a requirement separately sets prices for various geographical subregions. Thus, prices would be highest in the regions with the most severe capacity shortages, which would encourage additional generators to enter the region and compete for business.

In response to the FERC's directive, the ISO-New England proposed a "locational capacity" market structure in March 2004 that included four subregions, each of which would have a monthly auction for capacity. The auctions would be based on an administratively determined demand curve that would establish the price and quantity of capacity that must be procured within each subregion. The FERC commended the ISO-New England for adopting a locational pricing mechanism that took account of transmission constraints between different subregions within New England. Because the demand curve proposed by the ISO-New England was extremely controversial, numerous parties submitted comments and testimony regarding the proper height and slope of the curve. The FERC set the matter for hearing before an administrative law judge.

In June 2005, the administrative law judge issued a 177-page order largely accepting the ISO-New England's proposed demand curve. Several parties filed exceptions to this decision, arguing that the administrative law judge had wrongfully excluded evidence and had failed to respond to comments about flaws in the ISO-New England's demand curve. On September 20, 2005, the full FERC heard argument and subsequently established settlement procedures.

After four months of negotiations involving 115 parties, a settlement was reached. Only eight of these parties opposed the final settlement. The key feature of the settlement agreement was the Forward Capacity Market, which would replace the ISO-New England's earlier proposal and eliminate the need for the controversial demand curve. Under the Forward Market, there would be annual auctions for capacity held three years in advance of when the capacity would be needed. Each transmission provider would be required to purchase enough capacity to satisfy its installed capacity requirement, which is the minimum level of capacity necessary to maintain reliability on the grid. The Forward Market also included a locational component.

The most contentious issue regarding the Forward Market was the payments required from December 1, 2006, until June 1, 2010. The three-year lead time left a three-year gap between the first auction and the time when the capacity procured in that auction would be provided. The parties addressed this issue by negotiating a series of fixed payments to be paid to generators during the transition period. The agreement also provided that challenges to the transition payments and the final Forward Market auction clearing prices—regardless of whether the challenge is brought by a settling party, a nonsettling party, or the FERC—would be adjudicated under the highly deferential public interest standard rather than the usual just and reasonable standard.

On June 16, 2006, the FERC approved the settlement agreement, finding that, as a package, it presented a just and reasonable outcome for this proceeding consistent with the public interest.

The Maine Public Utilities Commission and the Attorneys General of Connecticut and Massachusetts sought review in the U.S. Court of Appeals for the District of Columbia, arguing that the FERC's approval of the settlement was arbitrary and capricious, contrary to law, and beyond the scope of FERC's jurisdiction. Among other things they asserted that the FERC unlawfully accepted a *Mobile-Sierra* provision that imposed the deferential public interest standard of review on rate challenges brought by nonsettling parties.

The court of appeals agreed, reasoning that the *Mobile-Sierra* doctrine applies a deferential standard of review to preserve the terms of the bargain agreed to by contracting parties. When a rate challenge is brought by a noncontracting third party, the court held the *Mobile-Sierra* doctrine does not apply; the proper standard of review remains the just-and-reasonable standard in section 206 of the Federal Power Act. *Maine Public Utilities Com'n v. F.E.R.C.,* 520 F.3d 464 (D.C. Cir. 2008).

NRG Power Marketing, LLC, and other energy companies that have settled with the FERC petitioned the Supreme Court for review.

CASE ANALYSIS

The Federal Power Act, 16 U.S.C. § 791a et seq., grants the Federal Energy Regulatory Commission exclusive jurisdiction over the transmission of electric energy in interstate commerce and the sale of electric energy at wholesale in interstate commerce by public utilities. Under the Act, proposed rates for the sale or transmission of power within FERC's jurisdiction must be just and reasonable and not unduly discriminatory or preferential.

The Federal Power Act provides that, when a party challenges a rate or charge, the FERC must adjudicate the challenge under the just-and-reasonable standard. The *Mobile-Sierra* doctrine carves out an exception to this rule. The *Mobile-Sierra* doctrine originated in the Supreme Court's twin decisions in *United Gas Pipe Line Co. v. Mobile Gas Service Corp., 3*50 U.S. 332 (1956), and *FPC v. Sierra Pacific Power Co.,* 350 U.S. 348 (1956).

The *Mobile-Sierra* doctrine provides that when two or more parties reach a negotiated settlement over a disputed rate, the FERC applies a strong presumption that the settled rate is just and reasonable, and the FERC may only set aside the contract for the most compelling reasons. The purpose of the *Mobile-Sierra* doctrine is to preserve the benefits of the parties' bargain as reflected in the contract, assuming that there was no reason to question what transpired at the contract formation stage.

Under the *Mobile-Sierra* doctrine, the FERC may abrogate or modify freely negotiated private contracts that set firm rates or establish a specific methodology for setting the rates for service only if required by the public interest. This doctrine recognizes the superior efficiency of private bargaining, and its purpose is to subordinate the statutory filing mechanism to the broad and familiar dictates of contract law. Thus, when the parties to a rate dispute reach a contractual settlement, the FERC must enforce the terms unless the public interest requires otherwise—that is, unless the negotiated rates might impair the financial ability of the public utility to continue its service, might cast upon other customers an excessive burden, or might be unduly discriminatory. In this case, the Supreme Court is presented with a question of first impression: may the FERC approve a settlement agreement that applies the highly deferential public interest standard to rate challenges brought by noncontracting third parties?

Petitioners argue that the court of appeals' rationale conflicts with the Supreme Court's decision in *Morgan Stanley.* In *Morgan Stanley Capital Group Inc. v. Public Utility District No. 1 of Snohomish County,* 128 S. Ct. 2733 (2008), the Supreme Court held that the FERC can abrogate contract rates only in "extraordinary circumstances where the public will be severely harmed." The court of appeals reasoned that applying the public-interest standard to nonparties would deprive them of their statutory right to review under the just-and-reasonable standard. Nevertheless, petitioners contend that *Morgan Stanley* explains that *Mobile-Sierra*'s public-interest standard is merely one application of that just-and-reasonable standard—the one that governs contract rates.

According to petitioners, the public-interest standard is a restriction on the FERC's authority to abrogate contracts, not private parties' authority to challenge them. They contend the public-interest standard applies whether the FERC's investigation is initiated in response to a contracting party's complaint, in response to a noncontracting party's complaint, or by the FERC acting *sua sponte.* Petitioners assert the public-interest standard was developed for the precise purpose of protecting the interests of noncontracting members of the public.

Petitioners argue that the Supreme Court premised the *Mobile-Sierra* doctrine on the sensible notion that rates negotiated by sophisticated buyers and sellers can be expected to be reasonable. According to petitioners, the expectation of reasonableness cannot logically vary with the identity of the person who challenges the rate. They say that contract rates agreed to in a competitive wholesale market can be expected to benefit consumers and other noncontracting parties, not just the contracting parties themselves.

It is the petitioners' position that the court of appeals' decision prevents *Mobile-Sierra* from providing any semblance of the contract stability the doctrine is supposed to provide—stability essential to critical infrastructure development. According to petitioners, a presumption protecting contract rates from just a few persons (contracting counterparties) while allowing everyone else to challenge them free of *Mobile-Sierra*'s restrictions provides no stability at all. Petitioners assert that the court of appeals' decision rests on a misunderstanding of contract principles. They explain that applying *Mobile-Sierra* to a nonparty's challenge does not bind the nonparty to the contract. They say the existence of the contract is simply a fact that makes the rate more likely to be reasonable.

The FERC filed a brief arguing that it acted reasonably and within its statutory authority in approving, as just and reasonable, a comprehensive settlement. The FERC points out that the settlement contained a provision stating that future challenges to certain rates established under the settlement would be governed by the public interest *Mobile-Sierra* standard of review. According to the FERC, the court of appeals erred in setting aside the FERC's exercise of discretion in approving this aspect of the settlement, as a result of two fundamental misunderstandings of the *Mobile-Sierra* standard.

First, the FERC claims the court of appeals erroneously believed the public-interest standard of *Mobile-Sierra* is applicable only to challenges to contract rates brought by contracting parties. Because it is the rate itself that is presumed just and reasonable, the FERC declares the presumption should apply irrespective of the identity of the party challenging the rate.

It is the FERC's position that *Morgan Stanley* made clear that the *Mobile-Sierra* public-interest standard is not an exception to the statutory just-and-reasonable standard; it is an application of that standard in the context of rates set by contract. The FERC says it is the just-and-reasonable standard to involve an inquiry into the public interest in the context of future challenges to rates set under this settlement agreement.

The FERC stresses that the Supreme Court has repeatedly held that the Federal Power Act's just-and-reasonable standard leaves the FERC with considerable discretion in setting rates. The FERC says it properly exercised that discretion in determining that the public-interest standard should be applied here. Although the rates covered by the settlement's public-interest review provision are not themselves contract rates to which the FERC was required to apply *Mobile-Sierra,* the FERC claims it carefully reviewed the settlement. As part of the review, the FERC claims it reasonably determined that the transition payments fell within a zone of reasonableness, that the auction process would produce just and reasonable rates, and that the interest in rate stability made the application of the public-interest test appropriate.

The respondents (including the Maine Public Utilities Commission and the attorneys general of Connecticut and Massachusetts) were parties to the contested FERC proceeding but object to the settlement agreement agreed to by other parties and approved by the FERC. They acknowledge that under the *Mobile-Sierra* doctrine, freely negotiated contracts by sophisticated buyers and sellers are presumed just and reasonable as between the two of them. When a party to such a contract challenges it, they say that the FERC may only provide relief if the party shows that the public interest, strictly defined, will be injured by the contract. In this case, however, the petitioners seek to use that public-interest standard to limit the respondents' ability to challenge rates imposed under a settlement that the petitioners adopted, but to which the respondents objected. According to respondents, applying the *Mobile-Sierra* doctrine in that manner would unmoor it from its foundations, converting it to a sword by which contracting parties can bind third parties to rates to which they never agreed.

Respondents assert the rates produced by the settlement are not "contract rates" to which the *Mobile-Sierra* presumption could apply in the first place. They claim the rates at issue in this proceeding are fundamentally different from the typical bilateral contracts that were at issue in *Mobile, Sierra,* and *Morgan Stanley.* They say the transition payments and the auction results are tariff rates of general applicability throughout New England. Respondents argue the *Mobile-Sierra* public-interest standard applies only to rates arising from freely negotiated private contracts, and not to tariff rates or to rates established as a result of a regulatory process.

Even assuming the *Mobile-Sierra* doctrine could apply to general tariffs, respondents contend its presumption of reasonableness does not apply to challenges brought by entities that objected to the settlement that produced the rates. Respondents explain the premise of the doctrine is that the sophisticated parties that enter wholesale energy contracts should be bound by their bargain, for they can be expected to negotiate a just-and-reasonable rate as between the two of them. Accordingly, respondents assert the doctrine restricts the ability of a contracting party to obtain regulatory relief from the obligations it voluntarily incurred. However, they argue the doctrine has no application to efforts by contracting parties to bind third parties to the contractual terms. While the Federal Power Act properly holds a contracting party to an improvident bargain, respondents say the statute cannot reasonably be construed as binding a nonsettling party to an improvident bargain to which it objected. They assert the nonsettling party is entitled to have the FERC review the rates under the ordinary just-and-reasonable standard.

Responding to the argument that allowing nonparties to challenge contractual rates under the ordinary standard would eviscerate the *Mobile-Sierra* doctrine because "hordes" of consumers indirectly affected by the rates would be able to file challenges, respondents point out that they are not "indirectly affected" parties. To the contrary, they say, the settlement created a tariff mechanism setting the terms and conditions of service for all market participants in New England, including respondents. Respondents argue that the *Mobile-Sierra* doctrine does not permit settling parties to contractually bind nonsettling third parties to limit their challenges to a tariff derived from the settlement rate mechanism simply because the parties have agreed among themselves that such challenges should be limited.

Because the *Mobile-Sierra* doctrine does not apply to challenges by respondents to rates produced by the settlement, respondents say the court of appeals' judgment should be affirmed. Although FERC argues it has the authority to impose a *Mobile-Sierra* public-interest presumption in the absence of any contract from which such presumption might arise, respondents state that the FERC did not expressly raise this argument in lower courts and did not assert it in its brief in opposition. Respondents state the Supreme Court should therefore affirm the Court of Appeals' judgment without reaching this argument.

According to respondents, the FERC is also wrong when the FERC contends it has the discretion to apply a public-interest standard to challenges by respondents under its broad authority to approve contested settlement agreements it believes will produce just-and-reasonable rates. However, respondents claim neither the Federal Power Act nor any court precedent supports the proposition that the FERC may simply rewrite the terms of the Federal Power Authority based upon what the FERC believes may produce just-and-reasonable rates. While the FERC has the authority to establish or approve a mechanism to set capacity costs, respondents argue it does not have the discretion to abrogate the respondents' statutory rights under the Federal Power Act. Respondents state the FERC is not permitted to use its discretion to determine that the public-interest standard may be applied outside a contract context.

Respondents argue petitioners also err in asserting that affirmance would threaten industry stability. Respondents stress that the narrow issue before the Supreme Court is whether an entity that objected to a settlement can challenge rates that are produced by the settlement and imposed on them under the ordinary just-and-reasonable standard. According to respondents, a positive answer to the question will not undermine the *Mobile-Sierra* doctrine and the stability the doctrine advances. Respondents assert that, generally, parties that enter contracts understand that they generally cannot bind third parties to the contractual terms. They point out the FERC has applied the *Mobile-Sierra* public-interest standard to nonparties only since 2002, yet there is no evidence that industry stability was threatened before then.

SIGNIFICANCE

Petitioners assert that affirmance of the court of appeals' decision would threaten industry stability. They suggest that without a guarantee that contract rates will almost never be modified, producers and utilities will not invest sufficiently in the nation's energy infrastructure.

On the other hand, respondents say that the Federal Power Act gives substantial protection against unwarranted modification of existing contracts. They suggest that applying *Mobile-Sierra*'s public-interest standard would make it significantly harder for dissenting energy companies to challenge the rates that are imposed on them and then passed on to consumers in the form of higher prices.

Jay E. Grenig is a professor of law at Marquette University Law School in Milwaukee, Wisconsin. Professor Grenig is the author of *Alternative Dispute Resolution* published by Thomson Reuters/West. He is a member of the National Academy of Arbitrators. He can be reached at igrenig@earthlink.net or 414.288.5377.

PREVIEW of United States Supreme Court Cases, pages 112–115.

ATTORNEYS FOR THE PARTIES

For Petitioners NRG Power Marketing, LLC, et al. (John N. Estes III, 202.371.7338)

For Federal Energy Regulatory Commission (Elena Kagan, 202.514.2217)

For Respondents Maine Public Utilities Commission et al. (John S. Wright, 860.820.2684)

AMICUS BRIEFS

In Support of Petitioners NRG Power Marketing, LLC, et al.

Morgan Stanley Capital Group, Inc. et al. (Walter Dellinger, 202.383.5300)

Colin C. Blaydon et al. (Richard P. Bress, 202.637.2200)

Electric Power Supply Association et al. (Paul D. Clement, 202.737.0500)

In Support of Respondents Maine Public Utilities Commission et al.

American Public Power Association and the National Rural Electric Cooperative Association (Scott H. Strauss, 202.879.4000)

Public Citizen, Inc. and AARP (Scott L. Nelson, 202.588.1000)

Public Utilities Commission of the State of California (Kevin K. Russell, 301.941.1913)