

# Casenote

## **Deal or No Deal<sup>1</sup>: It's a Deal in *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1 of Snohomish County, Washington***

### I. INTRODUCTION

In *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1 of Snohomish County, Washington*,<sup>2</sup> the United States Supreme Court stood by the longstanding contract principles that generally uphold a mutually agreed upon contract freely entered into by parties.<sup>3</sup> The Court held that the only statutory standard for assessing wholesale electricity rates is the “just and reasonable” standard, which all electric energy contracts are required to meet pursuant to the Federal Power Act.<sup>4</sup> It further held that only when a contract rate seriously harms the consuming public will the rate be declared not just and reasonable.<sup>5</sup>

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1. “Deal or No Deal” is a registered trademark of Endemol Int'l B.V.
  2. 128 S. Ct. 2733 (2008).
  3. *See id.* at 2746.
  4. *Id.* at 2745; 16 U.S.C. §§ 791a-828(c) (2006).
  5. *Morgan Stanley*, 128 S. Ct. at 2746.

Furthermore, the Court held that under the *Mobile-Sierra*<sup>6</sup> presumption, which presumes that a contract is just and reasonable, a contract will not be invalidated unless “unequivocal public necessity” requires abrogation.<sup>7</sup>

## II. FACTUAL BACKGROUND

In the summer of 2000, California and other western states experienced a serious energy crisis. The events leading up to the crisis began unfolding in 1996 when the California legislature attempted to restructure California’s electricity market by enacting Assembly Bill 1890 (AB 1890).<sup>8</sup> AB 1890 established a nonprofit entity known as the California Power Exchange (CalPX) that operated a short-term electricity market known as the “spot market.” In effect, AB 1890 gave operational control of California’s three largest investor-owned utilities to an Independent Service Operator, deemed Cal-ISO, and required these investor-owned utilities to buy and sell the bulk of their electricity on CalPX’s spot market. AB 1890 also limited the utilities’ ability to enter into long-term contracts and capped the amount of power they could purchase outside of the spot market.<sup>9</sup>

In 1999 CalPX began auctioning sales of electricity under forward contracts.<sup>10</sup> The investor-owned utilities’ statutorily limited ability to purchase power outside the spot market restricted their participation in these forward contracts. This limited purchasing ability of the investor-owned utilities, along with an increase in the demand for electricity, an inadequate number of generating facilities, and environmental factors, caused prices on the spot market to soar.<sup>11</sup>

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6. *United Gas Pipe Line v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *Fed. Power Comm’n v. Sierra Power Co.*, 350 U.S. 348 (1956).

7. *Morgan Stanley*, 128 S. Ct. at 2748 (quoting *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968)).

8. Assem. B. 1890, 1995-96 Gen. Assem., Reg. Sess. (Cal. 1996) (codified at Cal. Pub. Util. Code §§ 330-398.5 (West 1996)).

9. *Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1 of Snohomish County, Wash.*, 128 S. Ct. 2733, 2742 (2008).

10. Forward contracts are contracts in which a seller agrees to provide a product more than one day in the future. *Id.*

11. *Id.* Other factors causing the market to soar included an inadequate number of generating facilities, a drought that caused a decrease in the availability of hydropower, an increase in unplanned outages, market manipulation, and unusually high temperatures. *Id.*

Seeking to stabilize the market in late 2000, the Federal Energy Regulatory Commission (FERC), which is authorized by the Federal Power Act<sup>12</sup> (FPA) to regulate the sale of electricity, ended its requirement that investor-owned utilities sell and purchase power through CalPX and encouraged the use of long-term contracts. FERC also placed price caps on wholesale electricity. The respondents, western utilities outside of California, took advantage of the ability to enter into these long-term contracts and purchased power from the petitioners, sellers of electricity. The parties were able to lock in rates that, although high by historical standards, were lower than what the parties would have paid on the spot market during the crisis.<sup>13</sup>

When the energy crisis passed and prices returned to normal, respondents asked FERC to modify their contracts, claiming that the *Mobile-Sierra*<sup>14</sup> presumption<sup>15</sup> should not apply.<sup>16</sup> FERC found that the *Mobile-Sierra* presumption applies when FERC has an initial opportunity to review a contract rate and that the initial opportunity for review in the instant case occurred during the grant of the market-based authority to petitioners.<sup>17</sup> FERC further concluded that the respondents could not overcome the *Mobile-Sierra* presumption. FERC also addressed reports of market distortions, noting that even if true, the

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12. 16 U.S.C. § 824 (2006).

13. *Morgan Stanley*, 128 S. Ct. at 2743.

14. *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *Fed. Power Comm'n v. Sierra Power Co.*, 350 U.S. 348 (1956).

15. Under the *Mobile-Sierra* presumption, mutually agreed upon contracts that are negotiated at arms-length and are freely entered into are presumed to be just and reasonable. *Morgan Stanley*, 128 S. Ct. at 2750.

16. *Id.* at 2743. The respondents claimed that given the seller's market-based tariffs, which provide that the seller will enter into voluntary contracts with the purchaser rather than putting forth rate schedules, the contracts were not initially approved by FERC without the presumption. *Id.* The respondents also claimed that even under the presumption, contract modification was appropriate because the high contract rates violated the public interest. *Id.*

17. Before reaching FERC, the case was heard before an Administrative Law Judge (ALJ). *Id.* at 2743. FERC issued a preliminary order instructing the ALJ to consider certain factors when determining whether the presumption could be overcome. *Id.* Some of these factors included the contract terms, available alternatives at the time the contract was entered into, the contract's effect on the financial health of the purchasers, and the extent to which contract modification would impact national energy markets. *Id.* The ALJ concluded that the *Mobile-Sierra* presumption applied and that the public interest was not seriously harmed by the contracts. *Id.* The ALJ also determined that contract modification was not appropriate even if the presumption did not apply. *Id.* Subsequently, FERC's staff issued a Staff Report indicating that prices in the forward market had been affected by unlawful activities of various sellers in the spot market and thus the distortions in the spot market carried over into the forward power prices. *Id.* at 2743-44.

findings were not determinative because they would be relevant only under a “just and reasonable” standard of review.<sup>18</sup>

The respondents petitioned the United States Court of Appeals for the Ninth Circuit for review, and the court reversed and remanded to FERC, finding flaws in the Commission’s analysis. The court of appeals agreed that rates are presumed to be just and reasonable only when FERC has an initial opportunity to review a contract. However, it additionally held that for FERC to satisfy that prerequisite, FERC must review contract terms promptly after they are formed and must modify contracts that are not just and reasonable when evaluated without the *Mobile-Sierra* presumption. The court of appeals further required that when FERC conducts the review, it must consider the market conditions during contract formation. Moreover, the court explained that when determining whether the *Mobile-Sierra* presumption is overcome, the standard used to evaluate a purchaser’s challenge to a contract—unlike the standard used to evaluate a seller’s challenge—is whether the contract rate exceeds a “zone of reasonableness.”<sup>19</sup>

The United States Supreme Court granted certiorari<sup>20</sup> and affirmed the court of appeals holding in a 5-2 decision.<sup>21</sup> Although the Supreme Court disagreed with the “zone of reasonableness” test and the rule requiring FERC to ask whether a contract was formed in an environment of market dysfunction, the Supreme Court nonetheless affirmed the court of appeals decision based on flaws in FERC’s analysis.<sup>22</sup>

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18. *Id.* at 2744. Because these were contract rates rather than tariffs, FERC determined that the appropriate standard of review was the “public interest standard,” and this standard cannot be overcome by showing that spot market dysfunctions caused forward prices to become unjust and unreasonable. Instead, FERC suggested that the respondents should have shown the contract rates, terms, and conditions undermined the public interest. The respondents attempted to meet this burden on rehearing, but the Commission was not convinced that there was sufficient evidence supporting a finding that market manipulation affected the specific contracts at issue. *Id.*

19. *Id.* at 2744-45. The court of appeals also held that although the application of the *Mobile-Sierra* presumption can be precluded by including a *Memphis Light* clause in the contract, the contract at issue did not contain any *Memphis Light* clause. *Id.* at 2745 n.2. This issue was not before the Supreme Court. *Id.*

20. *Id.* at 2745.

21. *Id.* at 2751.

22. *Id.* at 2745.

## III. LEGAL BACKGROUND

A. *Federal Power Act*

Congress enacted the Federal Power Act (FPA)<sup>23</sup> to help regulate the sale of electricity in interstate commerce.<sup>24</sup> The FPA authorizes the Federal Power Commission (Commission)<sup>25</sup> to regulate the sale of electricity by overseeing utility companies.<sup>26</sup> Under the FPA, utility companies are required to file rate schedules, or tariffs, with the Commission and to provide service according to the terms set therein.<sup>27</sup> Utility companies can also enter into bilateral contracts with individual purchasers to set rates.<sup>28</sup> These contracts must be filed with the Commission before they go into effect.<sup>29</sup> If a utility company wishes to change its tariffs, it is required to notify the Commission sixty days before the change is effective.<sup>30</sup> Furthermore, the FPA requires all rates to be “just and reasonable,”<sup>31</sup> but it does not define “just and reasonable.”<sup>32</sup>

Once filed, the Commission may suspend the rate pending an investigation to determine whether the rate is just and reasonable.<sup>33</sup> If a rate goes into effect and the Commission later declares it is not just and reasonable, the Commission can replace the unlawful rate with a just and reasonable rate, regardless of whether the Commission deemed the rate to be just and reasonable when the rate was initially filed.<sup>34</sup>

The FPA allows electricity rates to be changed using two methods.<sup>35</sup> First, § 205 of the FPA<sup>36</sup> authorizes a seller to unilaterally make a rate change.<sup>37</sup> Under this method, the rate is effective immediately after

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23. Ch. 687, 49 Stat. 847 (codified as amended at 16 U.S.C. §§ 791a-828c (2006)).

24. *Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1 of Snohomish County*, Wash., 128 S. Ct. 2733, 2737 (2008).

25. The Federal Energy Regulatory Commission’s (FERC) predecessor is the Federal Power Commission. *Id.* at 2738 n.1.

26. 16 U.S.C. § 824(b) (2006).

27. 16 U.S.C. § 824d(c) (2006).

28. *See* 16 U.S.C. §§ 824d(c)-(d) (2006).

29. *Id.*

30. *Id.* § 824d(d).

31. 16 U.S.C. § 824d(a) (2006).

32. *See id.*

33. 16 U.S.C. § 824d(e) (2006).

34. *Id.*

35. *Papago Tribal Util. Auth. v. F.E.R.C.*, 723 F.2d 950, 952 (D.C. Cir. 1983).

36. § 205, 49 Stat. at 851-52 (codified as amended at 16 U.S.C. § 824d).

37. 16 U.S.C. § 824d; *Papago*, 723 F.2d at 952.

the sixty-day notice required by subsection (d), but the rate is still subject to review by the Commission for a determination of justness and reasonableness.<sup>38</sup> Second, § 206 of the FPA<sup>39</sup> allows the Commission to change a rate if it finds the rate is “unjust, unreasonable, unduly discriminatory or preferential.”<sup>40</sup> Together, these two sections of the FPA essentially enable three contractual arrangements for rate revision: (1) an agreement that the utility can unilaterally and immediately impose new rates; (2) an agreement that the utility may not make unilateral changes; and (3) a waiver eliminating the utility’s right to make immediate changes under § 205 as well as the Commission’s power to impose changes under § 206 when rates are unjust and unreasonable.<sup>41</sup> Under any of these options, however, the Commission has authority to replace rates that are contrary to the public interest.<sup>42</sup>

In response to technological changes enabling new entrants to pierce a historically monopolistic market, FERC decided to foster competition by minimizing barriers to market entry.<sup>43</sup> Among other steps, the Commission began allowing market-based tariffs to be filed by wholesale electricity sellers instead of requiring fixed-rate contracts.<sup>44</sup> When parties file market-based tariffs, they essentially state that the seller and its purchasers will enter into freely negotiated contracts.<sup>45</sup> Contracts using these market-based tariffs avoid the FPA’s requirement that tariffs be immediately filed with the Commission because that requirement is presumed to be satisfied when the market-based tariffs are initially filed.<sup>46</sup> However, FERC will only approve market-based tariffs if the utility, among other things, is able to demonstrate that it has “adequately mitigated market power” and is unable to create

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38. 16 U.S.C. § 824d; *Papago*, 723 F.2d at 952. If the Commission intervenes to review the rate during this time period, the rate may be suspended for up to five months. 16 U.S.C. § 824d(e). If the Commission does not complete its proceedings within that five month period, the rate takes effect. *Id.*

39. § 206, 49 Stat. at 852 (codified as amended at 16 U.S.C. § 824e).

40. 16 U.S.C. § 824e(a); *Papago*, 723 F.2d at 952-53.

41. *Papago*, 723 F.2d at 953.

42. *Id.* Examples of when a rate might be contrary to public interest are when an excessive burden is cast upon other customers, the rate is unduly discriminatory, or the rate is so low it would impair the financial ability of the utility company. *Fed. Power Comm’n v. Sierra Pac. Power Co.*, 350 U.S. 348, 355 (1956). Like reasonableness, discrimination against the purchaser can be waived unless it harms the public interest. *Papago*, 723 F.2d at 953 n.4.

43. *Morgan Stanley*, 128 S. Ct. at 2740.

44. *Id.* at 2741.

45. *Id.*

46. *Id.*

barriers to market entry.<sup>47</sup> Further, if FERC determines that a seller of wholesale electricity has violated market rules, its tariff, or Commission orders, FERC can take remedial action against the seller.<sup>48</sup>

### B. *The Mobile-Sierra Presumption*

In 1956 the United States Supreme Court decided two cases addressing the Commission's authority to modify rates set by contractual agreement.<sup>49</sup> In *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*,<sup>50</sup> the Court addressed this issue as it pertains to the Natural Gas Act (NGA).<sup>51</sup> In that case, Mobile Gas Service Corporation (Mobile) contracted with United Gas Pipe Line Company (United) to purchase gas for distribution to its users.<sup>52</sup> The Commission approved the contract, and United, without Mobile's consent, later filed new schedules with the Commission purporting an increased rate.<sup>53</sup> When Mobile challenged the new rate, United asserted that the NGA's requirement that all utilities file new rates with the Commission was a rate-changing procedure authorizing gas companies to abrogate lawful contracts.<sup>54</sup> The Court disagreed, explaining that filing rates with the Commission is a precondition to changing the rates rather than a provision authorizing gas companies to unilaterally do so.<sup>55</sup> The Court further stated that United's argument lacked merit because the right is neither expressly given to the utilities by the NGA nor is the right otherwise possessed by them.<sup>56</sup>

The Supreme Court applied the holding from *Mobile* to a similar case involving the FPA because the relevant provisions of the FPA were substantially identical to the NGA's equivalent provisions.<sup>57</sup> In *Federal Power Commission v. Sierra Pacific Power Co.*,<sup>58</sup> Sierra Pacific Power Company (Sierra) agreed to purchase its electricity from Pacific Gas &

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47. *Id.* The utility also must continue to file reports with the Commission as well as demonstrate it still has mitigated market power. *Id.*

48. *Id.*; see Market-Based Rates, 72 Fed. Reg. 39,904, 39,906 (July 20, 2007).

49. *Morgan Stanley*, 128 S. Ct. at 2738 (referring to *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956) and *Sierra*, 350 U.S. 348).

50. 350 U.S. 332 (1956).

51. 15 U.S.C. §§ 717-717z (2006); see *Mobile*, 350 U.S. at 333-34.

52. *Mobile*, 350 U.S. at 335. The contract, which was approved by the Commission, stipulated that Mobile would purchase gas at a rate of 10.7 cents per MCF (thousand cubic feet). *Id.* at 336.

53. *Id.* at 336.

54. *Id.* United claimed that the rate had increased to 14.5 cents per MCF. *Id.*

55. See *id.* at 341-43.

56. *Id.* at 343.

57. See *Sierra*, 350 U.S. at 353.

58. 350 U.S. 348 (1956).

Electric Company (PG&E) in a fifteen year contract at a special low rate.<sup>59</sup> Five years later, PG&E filed new rates with the Commission, declaring a twenty-eight percent increase in its rate to Sierra.<sup>60</sup> Upon reviewing the rate, the Commission found that the new rate was lawful and declared the original rate unlawful because it was unreasonably low.<sup>61</sup>

On appeal, the Court held that PG&E's unilateral rate modification could not effectively change the contract between PG&E and Sierra.<sup>62</sup> The Court also concluded that the Commission's analysis was flawed, reasoning that a rate cannot be deemed unjust or unreasonable merely because it is unprofitable to the public utility company.<sup>63</sup> The purpose of § 206, FPA's provision giving the Commission power to change rates, is to protect the interest of the public and not the interest of the utility companies.<sup>64</sup> The Court asserted that although the Commission itself cannot normally impose an unreasonably low rate upon a public utility, accepting the Commission's argument would, in effect, indicate that public utilities who contractually agree to rates allowing a less than fair return are entitled to relief from a burden they imposed on themselves.<sup>65</sup>

In cases following *Sierra*, however, the Court noted that when considering a "zone of reasonableness" for a rate, under which there is not one fixed point of reasonableness, the Commission may consider what consequences the rate would have on the producers and the supply of electricity.<sup>66</sup> Nevertheless, the Court has held that abrogation of voluntary contractual agreements can occur only as required by unequivocal public necessity.<sup>67</sup>

The holdings from *Mobile* and *Sierra* became known as the *Mobile-Sierra* presumption, under which it is presumed that freely negotiated contractual rates are "just and reasonable" as required by the FPA.<sup>68</sup> Over the years, the presumption has been modified to expand freedom to contract.<sup>69</sup> In *United Gas Pipe Line Co. v. Memphis Light, Gas &*

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59. *Id.* at 352.

60. *Id.*

61. *Id.* at 354.

62. *Id.* at 353.

63. *Id.* at 354-55.

64. *Id.* at 355.

65. *Id.*

66. *Papago*, 723 F.2d at 954-55; *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 821-22 (1968).

67. *Permian Basin*, 390 U.S. at 822.

68. *Morgan Stanley*, 128 S. Ct. at 2737.

69. *Id.* at 2739.

*Water Division*,<sup>70</sup> the Supreme Court held that parties can bypass the *Mobile-Sierra* presumption by contracting for the current “going” rate.<sup>71</sup> In *Memphis Light*, the parties entered into a contract under which the seller would supply the purchaser of natural gas “under Seller’s Rate Schedule . . . or any effective superseding rate schedules, on file with the Federal Power Commission.”<sup>72</sup> The Court held that this contractual language leaves the utilities free to change their rates, subject to the statutory limitations.<sup>73</sup> The key difference between the contract in *Memphis Light* and the one in *Mobile* was that the utility in *Mobile* contracted away its right to change the rate.<sup>74</sup> Acknowledging that at times it may be economically necessary for gas companies to raise their rates and that the public must be protected from excessive gas prices, the Court in *Memphis Light* reasoned that protecting the financial stability of natural gas companies is in the public’s interest because the public, as consumers of the gas companies’ products, needs the companies to remain in business.<sup>75</sup>

In addition, parties may stipulate to authorize the Commission to set aside a contract rate if the rate yields an unfair return for the utility.<sup>76</sup> This stipulation would be in addition to the Commission’s ability to set aside a rate violating the public interest.<sup>77</sup> Parties cannot contract around § 206 authority, and an agreement attempting to do so would be void.<sup>78</sup>

As caselaw developed, the Commission and the courts began referring to two standards of review: the “public interest standard” and the “just and reasonable standard.”<sup>79</sup> The public interest standard, under which the Commission could modify rates only when they adversely affected the public interest, was viewed as the stricter standard.<sup>80</sup> The Commission understood this limitation to mean that third parties are protected from any excessive burden or undue discrimination.<sup>81</sup> This standard of review is applied with the *Mobile-Sierra* presumption, and

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70. 358 U.S. 103 (1958).

71. *Id.* at 110.

72. *Id.* at 105 (quoting the long-term service agreements between the parties).

73. *Id.* at 110.

74. *Id.* at 111.

75. *Id.* at 113.

76. *Morgan Stanley*, 128 S. Ct. at 2739.

77. *See Papago*, 723 F.2d at 954.

78. *Id.*

79. *Morgan Stanley*, 128 S. Ct. at 2740.

80. *See, e.g., Ne. Util. Serv. Co. v. F.E.R.C.*, 993 F.2d 937, 961 (1st Cir. 1993).

81. *See, e.g., id.*

thus the rates under review are presumed to be just and reasonable.<sup>82</sup> In contrast, the just and reasonable standard is applied without the *Mobile-Sierra* presumption<sup>83</sup> and is a less strict standard than the public interest standard.<sup>84</sup> Parties attempting to meet the just and reasonable standard must show merely that the rate imposed is for the benefit of the purchaser and the seller.<sup>85</sup> Ultimately, parties can contract around the just and reasonable standard, whereby the Commission would only intervene when the rates adversely affect the public interest.<sup>86</sup>

#### IV. COURT'S RATIONALE

##### A. *The Majority Opinion*

Writing for the 5-2 majority, Justice Scalia affirmed the ruling of the United States Court of Appeals for the Ninth Circuit on alternative grounds, holding that the Federal Energy Regulatory Commission (FERC) may find that a mutually agreed-upon contract is not just and reasonable only when the rate seriously harms the consuming public.<sup>87</sup> Additionally, the Court held that under the *Mobile-Sierra*<sup>88</sup> presumption, a contract may only be set aside when there is an “unequivocal public necessity” to do so.<sup>89</sup>

The Court began by agreeing with the court of appeals’ assertion that the just and reasonable standard is the only statutory standard for assessing wholesale electricity rates.<sup>90</sup> The Court reiterated that the Federal Power Act (FPA)<sup>91</sup> plainly states that all rates must be just and reasonable.<sup>92</sup> Beyond that, however, the Court disagreed with the remainder of the court of appeals’ analysis.<sup>93</sup> First, the Court opposed

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82. *Morgan Stanley*, 128 S. Ct. at 2740.

83. *Id.*

84. *See Papago*, 723 F.2d at 954.

85. *See id.*

86. *Morgan Stanley*, 128 S. Ct. at 2739; *Ne. Util.*, 993 F.2d at 961.

87. *Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1 of Snohomish County, Wash.*, 128 S. Ct. 2733, 2745-46 (2008). In its decision, the Court explicitly stated that it expressed no opinion on the lawfulness of the market-based tariff system. *Id.* at 2741.

88. *United Gas Pipe Line v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *Fed. Power Comm’n v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956).

89. *Morgan Stanley*, 128 S. Ct. at 2748 (quoting *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968)).

90. *Id.* at 2745.

91. 16 U.S.C. §§ 791a-828c (2006).

92. *Morgan Stanley*, 128 S. Ct. at 2745 (quoting 16 U.S.C. § 824d(a) (2006)).

93. *See id.* at 2745-49.

the assertion that the application of the just and reasonable standard depends on when the contract rate is challenged.<sup>94</sup> The Court stated that when evaluating a mutually agreed-upon rate set by a contract, as opposed to rates set by tariff, FERC should presume that the rate is just and reasonable, regardless of when the review occurs.<sup>95</sup> The Court stated that the only time a contract rate fails to meet this standard is when the rate seriously harms the public, which is a high burden to meet.<sup>96</sup> The Court clarified that the public interest standard is not a separate standard from the just and reasonable standard; it simply refers to a different application of the just and reasonable standard.<sup>97</sup> Ordinarily, contract rates are presumed to be just and reasonable, while rates set by tariffs are not.<sup>98</sup>

Next the Court noted that the court of appeals incorrectly held that FERC must investigate whether the contract was formed in a dysfunctional market before applying the *Mobile-Sierra* presumption.<sup>99</sup> The Court explained that not only does the FPA itself authorize contracts as alternatives to tariff-based regulation but also that a main reason parties enter into contracts, particularly long-term contracts, is to protect themselves against market volatility.<sup>100</sup> Therefore, the Court stated that a rule rendering these contracts unlawful simply because volatility occurred would be unsupported and would negate the incentive to enter into them.<sup>101</sup> This rule would also undercut the role of contracts as a key source of stability in the power market.<sup>102</sup> However, the Court qualified its holding by stating that if the market dysfunction was caused by the extensive illegal market manipulation of one of the parties, then the *Mobile-Sierra* presumption should not be applied.<sup>103</sup> Additionally, the Court noted that traditional reasons to abrogate a contract, such as fraud or duress, remain grounds for FERC to set aside a contract.<sup>104</sup>

The Court then expressed its disapproval of the zone of reasonableness test the court of appeals purported to use when a buyer claims a rate is

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94. *Id.* at 2745.

95. *Id.* at 2746.

96. *Id.*

97. *Id.* at 2740.

98. *See id.* at 2740, 2749 n.6.

99. *Id.* at 2746.

100. *Id.*

101. *Id.* at 2746-47.

102. *Id.* at 2746-47, 2749.

103. *Id.* at 2750.

104. *Id.* at 2747.

too high.<sup>105</sup> In its zone of reasonableness test, the court of appeals essentially assessed whether some consumers were paying higher than the margin cost to compensate for a below-the-margin rate charged to other consumers because this would allegedly place an excessive burden on the consumers forced to pay above the marginal cost.<sup>106</sup> Instead, the Court stated that the proper standard is whether the rate seriously harms the public interest and that this standard applies no matter which party challenges the rate.<sup>107</sup> The Court noted that the presumption of validity remains even when the rate is above marginal cost.<sup>108</sup> A rate that exceeds marginal cost is not the “unequivocal public necessity” required to set aside a contract rate under the *Mobile-Sierra* presumption.<sup>109</sup> The Court also pointed out the impracticalities of the Ninth Circuit’s rule.<sup>110</sup> The rule would be expensive and difficult to administer.<sup>111</sup> Furthermore, it would create uncertainty, which would negatively impact utility companies’ willingness to enter into long-term contracts, thereby harming customers in the long run.<sup>112</sup>

The Court next turned to FERC’s analysis, stating that the analysis was incomplete because FERC only considered whether rates paid by consumers immediately increased when the contracts went into effect rather than also determining whether the contracts imposed an excessive burden on consumers as compared to the rates that could have been obtained without the contracts after the market dysfunction ended.<sup>113</sup> The Court asserted that both the burden existing at the time the contract enters into effect as well as the burden at the time of trial are relevant when considering whether an excessive burden has been placed

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105. *Id.* The Court agreed with the court of appeals assertion that all of the factors identified in *Sierra* may not be applicable when evaluating a purchaser’s challenge that a rate is too high. *Id.* For example, the Court stated that when evaluating a purchaser’s challenge, a relevant factor to examine may be whether any customers of the purchaser are excessively burdened rather than whether other customers of the utility are burdened. *Id.* However, the Court was clear that the standard is the same no matter which party, the buyer or the seller, challenges a rate. *Id.* The factors identified in *Sierra* are (1) whether the rate impairs the financial ability of the utility, (2) whether the rate casts an excessive burden upon other consumers, and (3) whether the rate is unduly discriminatory. *Sierra*, 350 U.S. at 355.

106. *Morgan Stanley*, 128 S. Ct. at 2748.

107. *Id.* at 2747.

108. *Id.* at 2748.

109. *Id.* at 2748-49 (quoting *Permian Bason*, 390 U.S. at 822).

110. *See id.* at 2749.

111. *Id.*

112. *Id.*

113. *Id.* at 2749-50.

on the public.<sup>114</sup> The Court explained that even though long-term contracts support market stability, if the rates seriously harm the public or impose an excessive burden on consumers, they must be disallowed.<sup>115</sup>

Finally, the Court addressed FERC's error in applying the *Mobile-Sierra* presumption despite the possibility that market manipulation fostered the dysfunction in the market.<sup>116</sup> FERC did not consider allegations of market manipulation because it found that the high forward market prices did not overcome the *Mobile-Sierra* presumption.<sup>117</sup> The Court stated, however, that contracts should be presumed just and reasonable only when formed under fair, arms-length negotiations; thus, if the contracts were not formed under those conditions, then the presumption should not be applied.<sup>118</sup> This is true even if the manipulated market is a different but related market that may have affected the market in question.<sup>119</sup> The Court further explained that FERC can abrogate a contract only if a causal connection exists between the unlawful activity and the contract rate.<sup>120</sup> If a causal link exists, the *Mobile-Sierra* presumption should not be applied.<sup>121</sup> The Court stated that FERC's conclusion that there was no evidence of market manipulation may have resulted from FERC's improper application of the *Mobile-Sierra* presumption.<sup>122</sup> In addition, the Court noted,

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114. *Id.* at 2750.

115. *Id.*

116. *See id.* at 2750-51. Before the Court, FERC maintained that *Chevron* deference was appropriate and thus the Court should afford great deference to FERC. *Id.* at 2745. In *Chevron United States of America, Inc. v. Natural Resources Defense Council, Inc.*, the Supreme Court stated that deference should be accorded to an administrative agency's interpretation of a statutory scheme it administers. 467 U.S. 837, 844 (1984). In *Morgan Stanley*, the Court explained that although *Chevron* deference is usually appropriate, the *Chenery* doctrine requires the Court to not give deference when an administrative agency's justification offered before the Court is different from that provided in its opinion. *Morgan Stanley*, 128 S. Ct. at 2745. FERC's opinion stated that its authorization of the market-based rate authority satisfied the FPA's requirement that FERC have an initial opportunity to review a contract without the *Mobile-Sierra* presumption; however, once before the Court, FERC argued that there was no requirement that FERC have that initial opportunity. *Id.* Nonetheless, the Court held that the *Chenery* doctrine did not apply here because precedent required that FERC apply the *Mobile-Sierra* presumption. *Id.* The Court stated that although FERC provided a different rationale for the correct result, the Court is not required to remand the case for that reason. *Id.*

117. *Morgan Stanley*, 128 S. Ct. at 2750.

118. *Id.*

119. *Id.*

120. *Id.* at 2751.

121. *Id.*

122. *Id.*

circumstances surrounding contract negotiations, such as market manipulation, are important when considering whether an excessive burden has been placed on consumers compared to what they might have paid without the contracts.<sup>123</sup>

Thus, the Court affirmed and remanded the case with orders for FERC to clarify its decisions regarding whether market manipulation occurred and whether an excessive burden existed.<sup>124</sup>

### B. Justice Stevens's Dissent

Justice Stevens, joined by Justice Souter, rejected the majority's claim that the FPA requires a differing application of the just and reasonable standard, asserting that nothing in the FPA requires a differing application of the statutory standard.<sup>125</sup> To the contrary, Justice Stevens argued that Congress's inclusion of contracts within the scope of § 206 indicates its belief that "contract defenses are insufficient to protect the public interest."<sup>126</sup> He suggested that FERC should be able to review contracts for justness and reasonableness unless they are formed under fraud or duress.<sup>127</sup>

Moreover, Justice Stevens contended that the majority's interpretation of the FPA's provisions proffered too many detailed constraints on FERC's authority.<sup>128</sup> Specifically, Justice Stevens denounced the majority's interpretations finding a mandatory presumption for contracts and its prohibition of FERC's consideration of marginal costs.<sup>129</sup> Justice Stevens insisted that the phrase "just and reasonable" is a general phrase intentionally used by Congress to give FERC discretion in setting policy.<sup>130</sup> He stated that the majority created rigid guidelines by which FERC must abide, and those rules contravene FERC's statutory authorization.<sup>131</sup> He also stated that, unless the statute commands otherwise, FERC should be able to make pragmatic adjustments as necessary.<sup>132</sup> Justice Stevens agreed with the majority's position that long-term contracts facilitate market stability; however, he determined that the FPA authorizes FERC, rather than the courts, to

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123. *Id.* at 2748 n.4.

124. *Id.* at 2751.

125. *Id.* at 2752 (Stevens, J., dissenting)

126. *Id.* at 2758.

127. *See id.* at 2757-58.

128. *Id.* at 2752.

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.* at 2753 (quoting *Permian Basin*, 390 U.S. at 776-77).

balance the short-term and long-term interests of consumers.<sup>133</sup> Justice Stevens insisted that Congress did not intend for contract rates to be immune from review of justness and reasonableness.<sup>134</sup> Accordingly, Justice Stevens suggested that the majority opinion incorrectly gives the impression that the FPA is subservient to the contracts between parties.<sup>135</sup>

Furthermore, Justice Stevens disagreed with the majority's use of precedent to support its decision.<sup>136</sup> He believed that the holding of *Mobile* only states that utilities cannot abrogate contracts unilaterally by filing new rates with FERC.<sup>137</sup> Justice Stevens suggested that the Court in *Mobile* implied that but for the protection of the public interest provided by contracts, Congress would not have permitted rates established by contracts and that the contracts must be filed with FERC and made public.<sup>138</sup> Additionally, Justice Stevens stated that *Federal Power Commission v. Sierra Pacific Power Co.*<sup>139</sup> stands for the proposition that whether a rate is just and reasonable depends on the public interest, rather than the private interests of sellers, as stated by the majority.<sup>140</sup>

## V. IMPLICATIONS

The decision in *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1 of Snohomish County, Washington*<sup>141</sup> answered several important questions while leaving many others unanswered.

### A. Clarified Uncertainties

The Court's decision in *Morgan Stanley* confirmed that voluntary, arms-length contracts are to be encouraged because they help stabilize the market.<sup>142</sup> The Court stressed that contractual agreements will be upheld so long as they do not violate the public interest.<sup>143</sup> This "public interest" standard is merely a differing application of the "just

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133. *Id.* at 2756. Justice Stevens also disagreed with the Court's decision not to give deference to FERC, asserting that the majority mischaracterized FERC's orders and incorrectly concluded that *Chenery* does not apply. *Id.* at 2758-59.

134. *Id.* at 2753.

135. *See id.*

136. *See id.* at 2753-56.

137. *Id.* at 2754.

138. *Id.* (quoting *Mobile*, 350 U.S. at 339).

139. 350 U.S. 348 (1956).

140. *Morgan Stanley*, 128 S. Ct. at 2754.

141. 128 S. Ct. 2733 (2008).

142. *Id.* at 2749.

143. *Id.* at 2746, 2748.

and reasonable” standard required by the Federal Power Act (FPA).<sup>144</sup> Although parties cannot contract around that statutory requirement, parties can contract around the application of the *Mobile-Sierra*<sup>145</sup> presumption.<sup>146</sup> This statutory standard applies regardless of which party challenges the contract rate.<sup>147</sup> In addition, contracts may not be abrogated simply because they were formed during market dysfunction.<sup>148</sup> Typically, the only effect market dysfunction will have on energy contracts under review is whether the *Mobile-Sierra* presumption applies.<sup>149</sup> So long as the dysfunction was not illegally caused by the parties, the *Mobile-Sierra* presumption will apply.<sup>150</sup> Finally, the Court made it clear that fraud and duress remain grounds for setting aside a contract.<sup>151</sup>

*B. What Constitutes an Excessive Burden?*

The Court did not clarify what constitutes an excessive burden that would justify overturning a contract. However, the Court did state that a rate exceeding the marginal cost is insufficient to set aside the contract rate.<sup>152</sup> The Court also noted two additional considerations: (1) whether the consumer rates increased immediately after the contracts went into effect and (2) a comparison of the price consumers would pay in the future and the rates they could have obtained without the contracts when the market dysfunction ceased.<sup>153</sup> This suggests that the long-term effects of the rate are important, but it still does not define what would constitute an excessive long-term burden. Until future cases flesh this out, the Federal Energy Regulatory Commission (FERC) and the utility companies will be unsure of the exact parameters of what is an excessive long-term burden.

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144. *Id.* at 2740; 16 U.S.C. §§ 791a-828c (2006).

145. *United Gas Pipe Line v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *Fed. Power Comm'n v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956).

146. *Morgan Stanley*, 128 S. Ct. at 2739, 2750.

147. *Id.* at 2747.

148. *Id.* at 2750-51.

149. *Id.*

150. *Id.* at 2750.

151. *Id.*

152. *Id.* at 2748-49.

153. *Id.* at 2749-50.

*C. Application of the Mobile-Sierra Presumption to Third Party Rate Challenges*

In *Maine Public Utilities Commission v. F.E.R.C.* (“*Maine PUC*”),<sup>154</sup> decided three months before *Morgan Stanley*, the United States Court of Appeals for the District of Columbia Circuit held that the *Mobile-Sierra* doctrine does not apply when nonsettling third parties challenge a contract rate.<sup>155</sup> The court of appeals asserted that ruling otherwise would deprive third parties of their statutory right to have a rate reviewed using the just and reasonable standard.<sup>156</sup> FERC, which had previously held that the *Mobile-Sierra* presumption does apply to third party challenges,<sup>157</sup> began issuing opinions in line with the court of appeals decision in *Maine PUC*.<sup>158</sup> However, in light of the decision in *Morgan Stanley*, in which the United States Supreme Court declared that the *Mobile-Sierra* presumption applies whenever a contract is reviewed,<sup>159</sup> FERC sought, albeit unsuccessfully, a rehearing of *Maine PUC*.<sup>160</sup> Should a future court rule on this issue, because of the emphasis the Supreme Court placed on the stabilizing effects long-term contracts have on the market and the fact that a contract rate’s effect on third parties is taken into account when the *Mobile-Sierra* presumption is applied, it is likely the court would hold that the *Mobile-Sierra* presumption does apply to third party challenges.<sup>161</sup>

*D. Filing and Opportunity for FERC Review*

The Supreme Court in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*<sup>162</sup> acknowledged that the Natural Gas Act (NGA)<sup>163</sup> requires

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154. 520 F.3d 464 (D.C. Cir. 2008).

155. *Id.* at 477-78.

156. *Id.* at 478.

157. See *Nevada Power Co. v. Enron Power Mktg., Inc.*, 103 F.E.R.C. P. 61,353, 62,389 para. 41 (2003) (explaining that there is no precedent upon which to base an assertion that the *Mobile-Sierra* presumption does not apply to third party rate challenges).

158. See, e.g., *Duke Energy Carolinas, L.L.C.*, 123 F.E.R.C. P. 61,201 para. 10 n.10 (2008); *Westar Energy, Inc.*, 125 F.E.R.C. P. 61,027 para. 23 (2008); *Southern California Edison Co.*, 125 F.E.R.C. P. 61,096 para. 4 (2008).

159. *Morgan Stanley*, 128 S. Ct. at 2737, 2746.

160. See *Maine Pub. Utils. Comm’n v. F.E.R.C.*, Nos. 06-1403, 06-1427, 07-1193, 2008 U.S. App. LEXIS 24022 (D.C. Cir. Oct. 6, 2008) (denying FERC’s request for a panel rehearing).

161. See *Morgan Stanley*, 128 S. Ct. at 2746-47.

162. 350 U.S. 332 (1956).

163. 15 U.S.C. §§ 717-717z (2006).

that all rates and contracts be filed with the Commission,<sup>164</sup> and in *Federal Power Commission v. Sierra Power Co.*<sup>165</sup> it recognized that many provisions of the FPA and NGA are substantially identical.<sup>166</sup> Before the Court decided *Morgan Stanley*, the Public Utility Law Project of New York, Inc. (PULP) filed an amicus brief urging the Court not to apply the *Mobile-Sierra* presumption to contracts.<sup>167</sup> PULP distinguished the contract at issue in *Morgan Stanley* from the ones in *Mobile* and *Sierra*, pointing out that the contracts in *Mobile* and *Sierra* were publicly filed in advance, giving interested parties time to react to the rates.<sup>168</sup> PULP argued that the parties involved in *Morgan Stanley* had not complied with the FPA's requirements of filing contract rates in advance, and therefore, the *Mobile-Sierra* presumption should not have been applied.<sup>169</sup> The Supreme Court acknowledged in *Morgan Stanley* that the FPA requires tariffs and contracts to be filed with FERC before they go into effect.<sup>170</sup> However, while the Court did not squarely address the issue proffered by PULP, it did hold that the *Mobile-Sierra* presumption should be applied when reviewing a contract no matter when the rate is challenged and that the only way to find a contract not just and reasonable is to determine that it seriously harms the consuming public.<sup>171</sup> Although the Court specifically stated that it neither approved nor disapproved of the lawfulness of the market-based tariff system,<sup>172</sup> if the Court were to directly confront the issue from PULP's amicus brief, the Court's analysis and its policy rationale imply that the *Mobile-Sierra* presumption would be applied to the contracts issued under the market-based tariffs. Given that FERC already operates by applying the presumption to contracts issued under market-based tariffs, that ruling would not likely have much of an impact on the utility industry.

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164. *Mobile*, 350 U.S. at 338.

165. 350 U.S. 348 (1956).

166. *Id.* at 353.

167. Brief of Amicus Curiae Public Utility Law Project of New York, Inc. in Support of Affirmance, *Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1 of Snohomish County, Wash.*, 128 S. Ct. 2733 (2008) (Nos. 06-1457, 06-1462), 2008 WL 163273, \*4.

168. *Id.* at \*10.

169. *Id.*

170. *Morgan Stanley*, 128 S. Ct. at 2737-38.

171. *Id.* at 2745-46.

172. *Id.* at 2741, 2747.