No. 06-1454

In the Supreme Court of the United States

SEMPRA GENERATION ET AL.,
PETITIONERS,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA ET AL.,
RESPONDENTS.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF OF PETITIONERS

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REVISED LIST OF PARTIES TO THE PROCEEDING

In the petition for certiorari, the following companies were erroneously listed as intervenors in the proceeding based on a mistake in the Ninth Circuit's docket sheet and were not in fact parties to the proceeding below: Southern California Edison Co.; Department of Water and Power of the City of Los Angeles; Public Service Department of the City of Burbank; Public Service Department of the City of Glendale; and Water and Power Department of the City of Pasadena.

Pursuant to Rule 14.1(b) of the Rules of this Court, petitioners submit a revised list of the parties to the proceeding, as follows:

Petitioners before the Ninth Circuit were the Public Utilities Commission of the State of California and California Electricity Oversight Board.

Respondent was the Federal Energy Regulatory Commission.

Intervenors were Pacific Gas & Electric Company; Nevada Power Company; Southern California Water Company (now known as Golden State Water Company); Sempra Generation; Mirant Americas Energy Marketing, L.P.; Coral Power, L.L.C.; PPM Energy, Inc.; Public Utility District No. 1 of Snohomish County, Washington; and Dynegy Power Marketing, Inc.

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ARGUMENT

This Court held in *Mobile* and *Sierra*[1] that the FPA preserves traditional contract law principles and permits parties to set rates by contract, just as before the Act—subject only to the Commission's limited authority to disturb those contracts in circumstances of extraordinary public necessity. In direct conflict with those decisions, the Ninth Circuit has now held that FERC *must* abrogate valid energy contracts even in the absence of public necessity whenever "dysfunctional" market conditions lead to "unreasonab[ly]" high contract rates. The Ninth Circuit also departed radically from the holdings of other circuits by directing FERC, asymmetrically, to use a "modified" and far less deferential public interest test whenever a buyer challenges its contract rate as "too high."

As amici attest, these holdings will have a devastating long-term impact on U.S. energy markets and consumers. That damage will persist regardless of FERC's decisions about these particular contracts on remand, irrespective of any incremental changes to FERC's market-based rate procedures, and despite FERC's protestation that nothing like the Western Energy Crisis will ever recur. Respondents miss the whole point of *Mobile*-Sierra, moreover, when they insist that review is unwarranted *because* the Ninth Circuit's decisions give FERC plentiful discretion to decide whether contract rates are fair to the parties. That is precisely why review is so vital.

1. All of Buyers' arguments share the same critical misconception: They assume the FPA's command that "all rates ... shall be just and reasonable," 16 U.S.C. § 824d(a), means that FERC must modify all existing contract rates that violate some abstract notion of "fairness." *See, e.g.*, Opp. of CPUC & CEOB ("CPUC Opp.") at 15; PUD Opp. at

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[1] *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956). This reply brief uses the same shorthand references used in the petition. Also, Respondents other than FERC are collectively referred to herein as "Buyers," and Petitioners are referred to as "Sellers."

12. But Congress unequivocally did not give FERC the authority to override the parties' determination that their agreed-upon rate *is the just and reasonable rate.* That is the central insight of *Mobile-Sierra.*

The FPA is "premised upon a continuing system of private contracting," *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968), and must be construed so as to reconcile traditional contract principles with its regulatory aims. *See Mobile*, 350 U.S. at 344. The *Mobile-Sierra* doctrine achieves that balance by allowing buyers and sellers to decide the "'just and reasonable' rate as between the two of them," *Verizon Commc'ns Inc. v. FCC*, 535 U.S. 467, 479 (2002), and permitting FERC to modify valid contracts only "when necessary in the public interest." *Mobile*, 350 U.S. at 344; *see also Permian Basin*, 390 U.S. at 821.

Under familiar common law principles, a contract is enforceable absent a defense such as fraud, duress, or mutual mistake, unless its enforcement would violate an overriding public policy. Restatement (Second) of Contracts § 178 (1981). The FPA does not alter these principles; it simply delegates to FERC "in the first instance" the authority to determine when enforcement of a wholesale electricity contract is manifestly contrary to the public interest. *Sierra*, 350 U.S. at 355.

Here, FERC found no "unfairness, bad faith, or duress in the original negotiations"; rather, "the contracts at issue were the result of choices" Buyers "voluntarily made." Pet. App. 118a–119a. Under *Mobile-Sierra*, all that was left for FERC to decide was whether the contracts were contrary to the public interest. FERC found they were not. Pet. App. 224a. Its judgment should have been affirmed.

2. According to Buyers, this Court in *Mobile* and *Sierra* presumed the challenged contract rates were "just and reasonable" only because FERC previously had an opportunity to review the justness and reasonableness of the rates. CPUC Opp. at 12; PUD Opp. at 11–14. Buyers claim FERC had no equivalent opportunity here to take into account "dysfunctions" in the market at the time the

contracts were formed. Their argument fails at every turn.

a. Contrary to Buyers' suggestion, in *Mobile* and *Sierra* this Court did not find the filing of the contracts with FERC to be legally significant. Buyers' theory appears to be that the Court implicitly adopted a novel species of regulatory estoppel that bars a party from later complaining about its freely negotiated rates *only if* the party could at the outset have challenged those rates at FERC. This Court never actually articulated such a theory, and as a practical matter it makes little sense, for a party is highly unlikely to challenge an agreement it just signed.

b. Even if an advance opportunity for review were essential to the holdings in *Mobile* and *Sierra*, FERC had such an opportunity here. *See* Sempra Pet'n at 18–20. FERC concedes that its market-based framework involved an "intensive factual review of the relevant product and geographic markets," FERC Opp. at 6, and, insofar as staleness is concerned, FERC found that Petitioner Sempra lacked market power *just three weeks before* Sempra signed its contract with CDWR.[2] Further, FERC found that everyone was fully aware of the extraordinary conditions affecting the Western power markets at the time, and yet Buyers did not challenge Sellers' market-based rate authority under FPA § 206 *before* they entered the agreements they now seek to undo.[3]

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[2] Respondents CPUC & CEOB contend that Sempra "disavowed any suggestion that the market was competitive" in its February 2001 application seeking market-based rate authority. CPUC Opp. at 18 n.11. That is untrue. While Sempra acknowledged FERC's recent efforts to remedy high spot market prices, it noted that it easily passed FERC's established market power analysis. Sempra recognized that FERC could, if appropriate, impose prospective conditions on market participants—and merely sought to be put on the same footing as other wholesale sellers. *See* FERC Docket No. ER01-1178-000 (Feb. 6, 2001). CEOB fails to mention that it intervened in that proceeding but raised no objections.

[3] *See* 16 U.S.C. § 825*l*(b) ("No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do.").

c. Buyers' attempts to question the fairness of their contract rates post hoc not only fly in the face of *Mobile-Sierra* but also disregard the statutory finality concerns that underlie the filed rate doctrine. The filed rate doctrine states that, once FERC accepts a rate as effective, it is "'presumed just and reasonable until the Commission determines otherwise.'" *Boston Edison Co. v. FERC*, 856 F.2d 361, 369 (1st Cir. 1988) (citation omitted). An effective rate cannot be collaterally challenged, and retroactive remedies are unavailable even if FERC later determines the effective rate is not just and reasonable. *Id.* at 372–73; *see also Montana-Dakota Utils. Co. v. Nw. Pub. Serv. Co.*, 341 U.S. 246, 250–51 (1951). Both the First and Ninth Circuits have held that market-based rates are entitled to filed rate protection. *See Pub. Util. Dist. No. 1 of Snohomish County v. Dynegy Power Mktg., Inc.*, 384 F.3d 756, 761 (9th Cir. 2004), *cert. denied*, 545 U.S. 1149 (2005); *Town of Norwood v. New England Power Co.*, 202 F.3d 408, 419 (1st Cir. 2000).

Buyers do not dispute that they knew their contracts would take effect immediately and remain enforceable absent a finding by FERC that the public interest required modification. In fact, CDWR demanded that its contract with Sempra expressly state that its rates, terms, and conditions were just and reasonable and would remain so regardless of changes in market conditions. *See* Sempra Pet'n at 23. The provision was added precisely to avoid the legal uncertainty the Ninth Circuit's decision has created.

d. The Ninth Circuit's holding that FERC can vitiate a contract whenever it believes "factors exogenous to the forward market" resulted in unfair rates, Pet. App. 321a, makes no economic sense and will itself introduce dysfunction into workably competitive forward markets. Even if FERC had authority to modify an existing contract for reasons besides public necessity, the alleged "dysfunctions" here do not reveal any competitive failure in the forward markets or in the formation of these contracts, and cannot justify contract modification under any legal theory.

Prices in a forward market *necessarily* reflect expecta-

tions about future spot market prices. Here, the contracting parties had access to the same information about conditions affecting Western electricity prices—including the high demand for and tight supply of electricity, California's flawed market scheme, the potential for manipulation of spot market prices, and FERC's corrective measures. The parties also equally faced the risk that their expectations about future prices could be wrong. The Ninth Circuit's insistence that Buyers may have been "victim[s]" of "dysfunctional market conditions," Pet. App. at 319a, is just another way of saying they should be relieved from what, in retrospect, they view as improvident bargains. *See Sierra*, 350 U.S. at 355. The holding that such market "dysfunction" constitutes a new contract defense is especially dangerous because it permits FERC to modify contracts based on an impossibly vague standard—not even FERC knows exactly what "dysfunction" is or how it would apply in a contract challenge. *See, e.g.*, FERC Opp. at 17 (Ninth Circuit "did not explain its alternative approach in any detail.").

3. Buyers argue that the FPA's focus on consumer welfare supports the Ninth Circuit's holding that the public interest compels abrogation of any contract rate that is in hindsight "unjustifiably" high, regardless of the long-term consequences for the nation's energy supply. Pet. App. 325a; *see* CPUC Opp. at 19–20; PUD Opp. at 16. That argument cannot be reconciled with this Court's recognition that the Act restricts FERC's authority to modify contracts precisely because contractual certainty is essential to ensuring the stable energy supply on which the consuming public relies. *See Mobile*, 350 U.S. at 344. Buyers also fail to explain where the Ninth Circuit got the authority to second-guess FERC's judgment that the long-term benefits of enforcement outweighed any short-term consumer benefits of modifying these contracts. *See* Sempra Pet'n at 26–28.

Buyers defend the Ninth Circuit's decision to rig the public-interest analysis against sellers, insisting this asymmetry is mandated by the statute's focus on consumer welfare. *See* CPUC Opp. at 25; PUD Opp. at 16. That

argument disregards the FPA's policy favoring contract stability, which requires "a certain symmetry to the ratemaking process." *Boston Edison*, 856 F.2d at 372. Although FERC can and should consider different factors when assessing the public interest in different circumstances, it is not free in any circumstance to circumvent *Mobile-Sierra* by "conflat[ing] the 'just and reasonable' and 'public interest' standards," *Ne. Utils. Serv. Co. v. FERC*, 993 F.2d 937, 961 (1st Cir. 1993), and certainly may not do so to advantage buyers only.[4]

4. FERC's opposition to certiorari is hard to reconcile with its prior arguments in this case,[5] but, as amici Electric Power Supply Association et al. ("EPSA") observe, it is "not entirely unexpected," for FERC "has a longstanding, well-documented record of ambivalence toward *Mobile-Sierra*." Amici Br. of EPSA at 18. Indeed, courts routinely have had "to remind [FERC] that it is not free to ignore the doctrine." *Sam Rayburn Dam Elec. Coop. v. FPC*, 515 F.2d 998, 1005 (D.C. Cir. 1975). Moreover, as EPSA notes, an "unprecedented degree" of "political pressure" has been put on FERC's Commissioners (none of whom were in office when it dismissed the complaints below) to reverse course in these cases.[6]

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[4] *South Carolina Generating Co. v. FPC*, 249 F.2d 755 (4th Cir. 1957), is not to the contrary. The court there addressed FERC's review under § 205(e), not § 206. *See id.* at 762. Even if CPUC's characterization of that case were correct, however, that would simply illustrate a further conflict with decisions of the First and D.C. Circuits and provide more support for granting review in this case. *See* Sempra Pet'n at 24–26.

[5] In dismissing the complaints, FERC accepted its lack of authority to modify a valid contract except in extraordinary circumstances of public necessity. Pet. App. 94a. FERC again acknowledged that limitation in defending its orders to the Ninth Circuit. *See, e.g., Pub. Utils. Comm'n of Cal. v. FERC*, Nos. 03-74207 etc. (9th Cir. 2006), Br. of FERC at 28.

[6] Amici Br. of EPSA at 19; *see also* Notes, *The Ambit of FERC Jurisdiction Over Electricity Contracts During Insolvency*, 104 Colum. L. Rev. 1947, 1990 n.170 (2004) (FERC faced "considerable political pressure" in connection with Western Energy Crisis, including Senate delay of FERC Chairman Joseph T. Kelliher's confirmation vote in 2003); Letter from Senator Barbara Boxer to Chairman Joseph T. Kelliher, FERC Docket

a. FERC's insistence that it has "sufficient discretion" under the Ninth Circuit's decisions "to consider all relevant factors" on remand, FERC Opp. at 12, itself demonstrates why review is necessary. The *whole point* of *Mobile-Sierra* is that FERC lacks statutory authority to consider factors besides public necessity in deciding whether to modify a valid contract. *See Permian Basin*, 390 U.S. at 821. FERC fails to explain why the public interest test is insufficient for FERC to carry out its statutory mandate.

b. FERC maintains that "it is unclear how" the Ninth Circuit's position "differs, in practical effect, from that of the Commission," FERC Opp. at 17, but it is patently clear that the court's holdings confer upon FERC unprecedented power to interfere with private contracts, without a finding of public necessity, whenever FERC believes the "context" in which a contract was executed led to unfair rates. If that newfound power truly made no difference, then the Ninth Circuit would have affirmed. And while FERC correctly observes that this difference *might not* ultimately "be outcome-determinative in this or any other case," *id.* at 18, that indeterminacy is precisely what Congress sought to avoid. As FERC previously recognized, the Ninth Circuit's approach fails to "protect the parties' contractual expectations as envisioned by [this Court]." Pet. App. 130a.

c. FERC argues that the Ninth Circuit's holdings are only "of historical interest" because FERC has since beefed up its market-based regulatory scheme. FERC Opp. at 14. FERC's argument ignores that there is still a lot at stake for the parties—the challenged contracts involve over $12 billion in long-term power sales—and is contradicted by the amici briefs of numerous industry groups who detail the serious harm that the Ninth Circuit's decisions will cause.

No. EL02-60 (March 28, 2007) (urging "FERC to inform the Solicitor General that it accepts the Ninth Circuit's decisions" and advising FERC to "reject any efforts to appeal, and immediately move forward with determining the refunds due to California consumers"). Chairman Kelliher, whose term recently expired, is once again awaiting a Senate vote on his reappointment.

Moreover, FERC's modifications to its regulatory scheme do not actually cure the two deficiencies the Ninth Circuit found most significant. Under the revised procedures, FERC's market-based analyses are still not contemporaneous with every market-based transaction, and disgruntled buyers therefore can still argue that FERC's analysis has grown "stale." *See id.* at 316a. And of course FERC has done nothing to insulate market-based transactions from the potential that "dysfunctions" will be alleged in "hindsight."[7]

d. FERC also insists that certiorari is unnecessary because it is unlikely that "market dysfunction of the kind that occurred in the 2000-2001 western energy crisis" will recur. FERC Opp. at 18. That blind optimism—which the agency has mistakenly evinced before[8]—ignores the realities of our energy markets, which "are susceptible to periods of inelastic demand and supply," making energy particularly prone to "large, sudden shifts in price." Amici Br. of EPSA et al. at 8; *see also CERA Report* at 5. It is simply naïve to believe that future energy markets will be free from the impacts of manipulation, or that manipulation can be detected and remedied in real-time.[9] Moreover,

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[7] Many of the features FERC claims are "new and improved" were in place when Sellers signed their contracts with CDWR. For instance, Sellers were required to file after-the-fact transaction reports with FERC and had to notify FERC when any relevant characteristics changed. *See, e.g., Sempra Energy Resources*, FERC Docket No. ER01-1178 (Letter Order) (Apr. 10, 2001); *see also* FERC Opp. at 4–5. At odds with its argument here, FERC recently found that the market-based procedures it had in place when Sellers entered these contracts are legally sufficient to satisfy FPA § 205. *See Market-Based Rates for Wholesale Sales of Elec. Energy, Capacity and Ancillary Servs. By Pub. Utils.*, Order No. 697, 119 FERC ¶ 61,295, at ¶¶ 843, 854 (2007) ("Order No. 697") (rejecting argument that all market-based rate sellers must provide updated market power analyses to satisfy FPA § 205).

[8] Cambridge Energy Research Assocs., *California Power Crisis Aftershock: The Potential Modification of Western Power Contracts* ("*CERA Report*") at 23 (Apr. 2007) (noting that FERC has described past instances of extreme volatility as "particular" and "not likely to recur").

[9] Indeed, less than a month ago FERC found that certain energy market participants directly or indirectly manipulated prices for bilateral

periods of extreme volatility are when it is most important to encourage more production and market entry, yet the Ninth Circuit's order prevents parties from achieving contractual certainty under FERC's market-based regime.

e. FERC argues that the Ninth Circuit's decisions do not conflate the public interest inquiry with the "just and reasonable" standard applicable outside the *Mobile-Sierra* context. FERC Opp. at 19–22. It relies on the Ninth Circuit's suggestion that a contract rate exceeding marginal cost may still survive public interest scrutiny if it "trend[s] toward rates that do reflect [marginal] costs." Pet. App. 326a. But the traditional "just and reasonable" test can also accommodate rates above marginal cost.[10] The distinction that eludes the Ninth Circuit is that the public interest test places great weight on contract certainty, which Congress recognized is critical to a stable supply of energy.[11]

FERC also argues that the decisions here are "poor vehicle[s]" for this Court to consider the Ninth Circuit's modified public interest test, because the court of appeals' comments on the topic were not necessary to its decision. FERC Opp. at 21. That is untrue. If FERC decides on remand that the contracts should be presumed reasonable, then it will have to apply the Ninth Circuit's "modified form of *Mobile-Sierra* review." Pet. App. 15a. FERC also states that this Court should await a better-developed record, but there is no reason to defer review because the Ninth

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contracts for physical deliveries of natural gas from 2003 through 2006. *See Amaranth Advisors L.L.C.*, 120 FERC ¶ 61,085, ¶ 140 (2007); *Energy Transfer Partners, LP.*, 120 FERC ¶ 61,086, ¶ 140 (2007).

[10] For instance, FERC permits wholesale sellers found to have market power to price their long-term contracts based on total (or "embedded") costs over the life of the contract, even if such prices exceed marginal cost. *See* Order No. 697, 119 FERC ¶ 61,295, ¶ 659.

[11] FERC's doubt that "'*any* direct impact on consumer rates [will be] enough ... to displace the countervailing *Mobile-Sierra* concern with protecting" contract stability, FERC Opp. at 19–20 (quoting Pet. App. 326a), is belied by the Ninth Circuit's comment that the public interest may require abrogation even absent any consumer rate increase if consumer prices would be lower but for the contract. Pet. App. 13a–14a.

Circuit's test applies generally to *every* high-rate challenge.

5. Buyers' attempts to downplay the potential impact of the Ninth Circuit's decisions are belied by the thirteen industry groups—representing hundreds of electric generators, oil and gas producers, gas pipelines, traders, and major financial institutions in the United States and Canada—submitting amici briefs explaining that the dramatic regulatory shift that these decisions portend will severely endanger the nation's energy markets. As amici explain, *Mobile-Sierra* plays a critical role in fostering market participation and investment in the inherently volatile energy markets by allowing buyers and sellers to manage their risks, secure in the knowledge that their contracts will be modified only when absolutely necessary to protect the public interest. The Ninth Circuit's decisions undermine these goals and expose sellers to the ever-present threat that their contracts will be undone whenever market or political conditions change.

Over the long haul, the decisions will have several inescapable effects, all of which are bad for consumers. First, they will reduce investment in infrastructure (including in new renewable technologies). Second, they will discourage the use of long-term contracts, which are needed to maintain adequate supplies, provide reliability of service, and hedge against price volatility in times of crisis.[12] And third, they will result in higher prices because contracting parties will demand risk price premiums or be forced into inefficient cost-based ratemaking to achieve greater certainty. CERA estimates that, unless they are reversed, these decisions will cost consumers tens of billions of dollars in the next 15 years. *See CERA Report* at 20-22.

CONCLUSION

The petition for certiorari should be granted.

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[12] Approximately $400 billion in capital expenditures will be required by the electric sector over the next 15 years, *CERA Report* at 16, and as *amici curiae* explain it is exceedingly difficult for a supplier to obtain project funding without stable long-term sales contracts.

Respectfully submitted,

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