Energy Litigation Journal

SECTION of LITIGATION
AMERICAN BAR ASSOCIATION

MOBILE-SIERRA AND MARKET-BASED REGULATION: HOW WILL THE SUPREME COURT STRIKE THE BALANCE?

By Jared S. des Rosiers and Deborah L. Shaw*

The ripple effects of the 2000-2001 energy crisis that hit the western United States with rolling blackouts and soaring spot market prices continue to be felt in the courts, as energy buyers battle to recoup some of the exorbitant costs of the power purchases they made during the crisis. One of those battles, between buyers and sellers of long-term contracts executed during the crisis, has now reached the U.S. Supreme Court.[1] In December 2006, the Ninth Circuit issued two related decisions[2] holding that the Federal Energy Regulatory Commission ("FERC" or "the Commission") erred in its application of the Supreme Court's *Mobile-Sierra* doctrine[3] to refuse to modify or abrogate power contracts entered into during the energy crisis. The sellers' appeal from one of these decisions presents the Court with its first opportunity to address the interplay between FERC's responsibility to review and fix rates under the Federal Power Act ("FPA"), FERC's current market-based rate regulatory scheme, and the Supreme Court's *Mobile-Sierra* standard for contract modification.

This article does not address the causes of the 2000-2001 energy crisis or FERC's actions to mitigate the crisis. It focuses instead on the broader question of the role of market-based rate contracts in the rate filing system envisioned by the FPA, and how the somewhat convoluted history of *Mobile-Sierra* helped the Ninth Circuit define that role. It begins with a review of the FERC and the Ninth Circuit decisions applying *Mobile-Sierra* to the market-based rate contracts entered into during the energy crisis, and the ensuing questions presented to the Supreme Court. From there, it argues that the Ninth Circuit did not, as some suggest, eviscerate *Mobile-Sierra* or upend FERC's market-based rate regime,[4] but instead extended the principles of *Mobile-Sierra* to market-based rate contracts in a way that respects both the dictates of the FPA and reasonable contractual expectations.

I. The Proceedings Below.

A. The FERC Decisions.

The cases now before the Court commenced in late 2001 with the filing of separate complaints by Nevada Power Company, Sierra Pacific Power Company, Public Utility District No. 1 of Snohomish County, and Southern California Water Company against various sellers of electricity in the western market. The buyers challenged the lawfulness under the FPA of the long-term bilateral contracts they entered during the energy crisis when the California Independent System Operator ("ISO") and Power Exchange ("PX") spot markets were "dysfunctional" as previously found by FERC. The crux of the complaints was that the challenged contracts were executed in a long-term market that was substantially infected by the dysfunctional spot market and were the result of the sellers' exercise of market power and market abuse. Accordingly, the contract rates that far exceeded those that would result from a workably competitive market were unjust and unreasonable under the FPA and should be modified.

[Cont'd on p. 4]

IN THIS ISSUE:

Mobile-Sierra and Market-Based Regulation--By Jared S. des Rosiers and Deborah L. Shaw	Pg. 1
Message from Co-Chairs	Pg. 2
Editor's Note	Pg. 3
The Filed Rate Doctrine and the 21st Century Natural Gas Sales--By Gregory C. Cook and Ed. R. Haden	Pg. 10
Potential Litigation Issues Arising from the Implementation of CREZ in Texas—By George H. "Greg" Williams, Jr.	Pg. 14

The Filed Rate Doctrine and 21st Century Natural Gas Sales – The Ninth Circuit Rules That Electricity is Not Gas

By: Gregory C. Cook and Ed R. Haden*

Over a year ago, this newsletter published our article discussing the growing split among courts over whether the Filed Rate Doctrine barred claims made by large purchasers of natural gas.[1] While there has been an avalanche of reported decisions applying the Filed Rate Doctrine to electricity claims – particularly those growing out of the Western Power Crisis of 2000-2001 – until recently there have been few on natural gas.

These electricity cases generally held that long-standing filed rate precedent barred state and federal damage claims of purchasers for market manipulation. These decisions reasoned that deregulation of the electricity market was not a statutory change and that the Federal Power Act ("FPA") continues to provide the Federal Energy Regulatory Commission ("FERC") jurisdiction over interstate wholesale sales of electricity.[2] In sum, these cases held that the "just and reasonable" standard still applies to wholesale sales of electricity; FERC merely expanded the method of setting "just and reasonable" prices for wholesale electricity sales, allowing the market to set prices under certain conditions and subject to various safeguards.

In the natural gas cases, the arguments focused on whether the Natural Gas Act ("NGA") and related statutes and the natural gas marketplace were the same as the Federal Power Act ("FPA") and the wholesale electricity marketplace. Plaintiff purchasers of natural gas during the 2000-2001 period argued that, in contrast to electricity, over the last twenty years, Congress had radically altered the 1930s era federal regime for natural gas. Today, rates for natural gas are determined by transactions that are expressly exempt from FERC's jurisdiction and therefore the Filed Rate Doctrine should not apply. Defendant sellers of natural gas argued that the Filed Rate Doctrine should apply the same in the gas context as it does in the electricity context because, among other things, the fact that both types of sales are now made in market trades, as opposed to cost-plus sales, does not displace the Filed Rate Doctrine's application.

Recently, the Ninth Circuit resolved these arguments in a group of four natural gas cases that had split the district courts. In *E. & J. Gallo Winery v. EnCana Corp., et al.,* the Ninth Circuit ruled that the Filed Rate Doctrine did not bar plaintiff's claims that various natural gas marketing companies manipulated the market during the Western Power Crisis of 2000 – 2001.[3]

Original Basis For Filed Rate Doctrine

As originally enacted in the 1930s, the FPA and NGA provided for the same FERC rate jurisdiction over wholesale sales of electricity and natural gas, the same requirement for the filing of tariffs (*i.e.,* rate schedules) for FERC's approval, and the same administrative review by FERC of challenges to rates.[4] Under this regime, FERC approved rates for interstate sales of natural gas for resale, and rates were restricted to a reasonable rate of return on prudently invested assets and recovery of prudent operating costs. Consistent with the original statutes, the Filed Rate Doctrine protected Congress's commitment of electricity and natural gas rate regulation to FERC.[5]

Statutory Deregulation vs. Regulatory Deregulation

The natural gas market however has changed dramatically over the last two decades. First, Congress statutorily exempted "first sales" of natural gas (*i.e.*, the sale of the gas from the well to a middleman for resale *and all subsequent sales* until a pipeline company, local distribution company, or affiliate resells the gas) from FERC jurisdiction beginning in 1993.[6] FERC's remaining jurisdiction is limited to a pipeline company's, local distribution company's, or their affiliate's interstate sale of natural gas for resale (if the natural gas is produced by another party (but not Canadian gas)), and any subsequent wholesale sale of that gas. Second, even for that narrow class of transactions, FERC does not require sellers of natural gas to file after-the-fact reports of sales in lieu of traditional tariffs and does not provide administrative review of gas rates for sales that Congress has exempted from its

jurisdiction.[7] FERC, by regulation, determined that all sales of natural gas, even by jurisdictional parties, would be at market prices.

Free Market Develops with Published Indices

As a result of deregulation, a commodities type market developed for the sale of natural gas at certain points. The market included term contracts for fixed time periods, futures (hedges), and spot prices. Various publishers began issuing indices for these markets. These indices were based upon the collection of sales information from both the regulated companies and the nonregulated companies. The publishers mix both types of gas sales into their formulas to produce an index price that is published. Many sellers incorporate the index by reference into their term contracts.

Manipulation Allegations

Plaintiffs allege in *Gallo* and other cases, that during the Western Power Crisis many of the natural gas marketing companies: (1) intentionally misreported information to the indices, (2) engaged in wash trading, and (3) acted in concerted ways to reduce supply of natural gas in the West.[8] These actions, allegedly, drove up the price of natural gas dramatically in the West. A FERC investigation indicated in its final report that some abuses did in fact exist ("Final Report").[9]

Ninth Circuit Decision

In *Gallo*, the Ninth Circuit explored in depth the arguments of both sides.[10] First, the court reaffirmed its holdings in the electricity context – that the Filed Rate Doctrine bars the claims of most purchasers for market manipulation, again noting that just because a price is determined by market forces does not mean that the Filed Rate Doctrine is inapplicable.[11] Thus, the Court held that market based rates for actual natural gas transactions under FERC's jurisdiction are FERC authorized rates and changing them cannot be the basis of federal or state claims.[12] Further, the court held that even a purchaser's status as a retail purchaser may not insulate their claim from the Filed Rate Doctrine if they are challenging FERC jurisdictional transactions.[13] Third, the court cited the "cost trapping" cases from the Supreme Court that hold that States (or courts) cannot penalize wholesale electricity or natural gas purchasers for having paid inflated wholesale rates.[14]

Cannot Recover on Theory that FERC Jurisdictional Rates Were Unfair

The Ninth Circuit rejected the argument made by some plaintiffs' that *Arkansas Louisiana Gas Co. v. Hall* ("*Arkla*") held that the Filed Rate Doctrine applies only to rates actually filed with FERC and did not apply where FERC was authorized to, but did not, require filings for certain sales (in *Arkla*, "small producer sales").[15] Therefore, the Ninth Circuit held that plaintiffs could not claim that mere regulatory action changed the Filed Rate Doctrine or that FERC authorized rates (even if not filed with FERC) were a result of wrongdoing.[16] Plaintiffs' claims would be barred by the Filed Rate Doctrine to the extent the indices included market based wholesale rates subject to FERC's statutory jurisdiction and plaintiffs sought to change those rates.

Summary Judgment Standard Not Met for Mixed Indices

In *Gallo*, the District Court denied summary judgment to the defendants under the Filed Rate Doctrine, but certified the question to the Ninth Circuit.[17] The Ninth Circuit affirmed and explained that the defendants can obtain summary judgment only if they can show that all transactions that comprise the indices are FERC authorized.[18] The court first stated that the indices are "not a rate itself."[19] The Ninth Circuit noted that the Filed Rate Defense was an affirmative defense (and thus the burden was on the defendant to prove it).[20]

Next, the court concluded that the Filed Rate Doctrine does not bar claims based upon indices comprised of both jurisdictional and nonjurisdictional prices.[21] The court observed that the Supreme Court had been very clear and that it would honor the line drawn by Congress between jurisdictional and nonjurisdictional transactions and that it was not enough that damages might have an "indirect[]" influence on jurisdictional transactions.[22]

The Ninth Circuit ruled that the plaintiffs had not met the summary judgment burden because the

indices included rates that are both jurisdictional and nonjurisdictional.[23] The court first explained that "first sale" transactions are outside of FERC's jurisdiction under the NGA and related statutes and therefore their inclusion in the indices does not create preemption or Filed Rate Doctrine defense.[24] The court also stated that preemption did not bar claims based upon "first sale" transactions because there was no express preemption language in the legislation that removed first sales from FERC's jurisdiction.[25] The omission "indicates a lack of intent" to preempt.[26] Second, the court noted that if index price inputs were misreported or wholly fictitious, then they are were not FERC approved rates.[27] Finally, the court noted that retail transactions are not regulated by FERC, and that their inclusion in the indices would not create a Filed Rate Doctrine defense.[28]

Other Opinions by Same Panel Further Explain Standard

The same Ninth Circuit panel that decided *Gallo* also heard several other similar cases (the remainder of cases were at the motion to dismiss stage). The panel released unpublished opinions in those cases, citing to *Gallo*, and providing some additional reasoning based upon some differences in allegations.

Preemption

Some defendants have sought rehearing. They argue that even if the Filed Rate Doctrine does not apply, preemption still prevents the application of state law to "first sales." Defendants rely primarily on *Transcontinental Gas Pipeline Corp. v. State Oil & Gas Board of Mississippi* ("*Transco*").[29] Plaintiffs had argued on original submission that *Transco,* however, barred express state rate regulation on gas sales, not a law of general application.[30] Moreover, a complete reading of the "just and reasonable" language in the statute demonstrates that it applies in the narrow context of allowing pass-through of costs incurred by interstate pipelines only.[31] Congress could not have intended to create a "gap" or "no man's land" of transactions where natural gas companies can engage in fraud or other misconduct free from the constraints of state laws (and federal law since there would be no FERC jurisdiction for such sales).[32]

Conclusion

One of the primary arguments offered by defendants had been the alleged impossibility of untangling the influence of the prices in the jurisdictional transactions on the non-jurisdictional transactions. This contention is largely predicated on the fact that jurisdictional and non-jurisdictional transactions occur in the same market, at the same time, between many of the same sellers, and are all included in the same indices. Because the market for natural gas in the West is not transparent, these indices have strong influence on short term (or spot) market and have an even stronger influence on the longer term sales (which often incorporate the indices directly into the contracts). Some defendants had gone further and argued that the "first sales" and large retail sales are all part of what they broadly label the "wholesale" market, and that FERC has exclusive jurisdiction over the "wholesale" market.

The Ninth Circuit rejected this argument. Nonetheless, the court recognized that its holding may create complexity because plaintiffs cannot challenge FERC authorized rates incorporated in the index but can challenge statutorily exempt rates in the index. This result, however, was compelled by the wording of the statute by Congress as well as Supreme Court precedent.

We Need Articles!
If you have ideas for articles that you would like to see in the Newsletter

Or

If you would like to submit an article

Please contact

Walter R. Mayer at

WMAYER@VELAW.COM

Or

Marty Truss at
JMTRUSS@COXSMITH.COM

[*] Gregory C. Cook is a partner of Balch & Bingham LLP in Birmingham, Alabama. He is co-chair of the Business Litigation Practice Group. Ed R. Haden is also a partner of Balch & Bingham LLP and the chair of the firm's Appellate Focus Group and member of the firm's Business Litigation Practice Group. Together with several colleagues at the firm, Greg and Ed represented Nevada Power Company in its appeal to the Ninth Circuit arguing that the filed rate doctrine did not bar that utility's claims against various natural gas suppliers for their manipulation of the gas market.

[1] *See* Cook & Haden, "*The Filed Rate Doctrine and 21st Century Natural Gas Sales*," 5 ABA Energy Litig. J. 1 (Summer, 2006).

[2] *Public Util. Dist. No. 1 v. IDACORP Inc.*, 379 F.3d 641, 651 (9th Cir. 2004); *Public Util. Dist. No. 1 v. Dynegy Power Mktg., Inc.,* 384 F.3d 756, 761 (9th Cir. 2004) (holding Filed Rate Doctrine barred claims on electricity sales within FERC's "jurisdiction" and for which sellers "file[d] quarterly reports . . . to ensure the rates will be on file as required by FPA § 205(c) ..."), *cert. denied*, 125 S. Ct. 2957 (2005); *California v. FERC*, 383 F.3d 1006 (9th Cir. 2004).

[3] 503 F.3d 1027 (9th Cir. 2007).

[4] *See* 16 U.S.C. §§ 824(b), 824d(c), 824e (a) (1997) (codifying FPA); 15 U.S.C. §§ 717(b); 717c(c); 717d (a) (1997) (codifying portions of NGA which parallel FPA).

[5] *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 966 (1986).

[6] *See* 15 U.S.C. § 3431(a)(a)(A) & § 3301(21) (Wellhead Decontrol Act of 1989); *see also* 15 U.S.C. § 3301, *et seq.* (Natural Gas Policy Act of 1978); 15 U.S.C. § 717b(b) (Energy Policy Act of 1992).

[7] *See* Order 2001, *Revised Public Utility Filing Requirements*, 99 FERC ¶ 61,107, 103 - 105, 2002 WL 977239, *18-*19 (2002); Order 547, *Regulations Governing Blanket Marketer Sales Certificates,* FERC Stats. & Regs. 30,957 (1992), *order on reh'g and clarification*, 62 FERC ¶ 61,239, 1993 WL 68660 (1993); Order No. 644, *Amendments to Blanket Sales Certificates*, 105 FERC ¶ 61,217, 2003 WL 22758080 (2003). Such authority was not required for gas produced by the pipeline, LDC, or their affiliate. *Public Serv. Comm'n of New York v. Mid-Louisiana Gas Co.,* 463 U.S. 319 (1983).

[8] *E & J Gallo Winery.*, 503 F.3d at 1030.

[9] *See* "Final Report on Price Manipulation in Western Markets," Federal Energy Regulatory Commission (2003).

[10] *Gallo*, 503 F.3d at 1033-49.

[11] *Id.* at 1039-42 (citing Public Utility District #1 of Grays Harbor County Washington v. IDACORP Inc., 379 F.3d 641, 651 (9th Cir. 2004)).

[12] *Id.*

[13] *Id.*at 1043-45 (citing *County of Stanislaus v. Pacific Gas and Elec. Co.*, 114 F.3d 858 (9th Cir. 1997)).

[14] *Id.* at 1043-44 (citing *Nantahala Power and Light Co.*, 476 US at 959).

[15] *Id.* at 1042 n. 12 (citing *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 576-78 & 584 n.14 (1981))

[16] *Id*. at 1042-43.

[17] *Id*. at 1032.

[18] *Id*. at 1048-49.

[19] *Id*. at 1043.

[20] *Id*. at 1039 n. 11.

[21] *Id*. at 1048.

[22] *Id.* (citing *Panhandle E. Pipeline Co. v. Public Serv. Comm'n*, 332 U.S. 507, 516-17 (1947); *American Gas Assoc. v. FERC,* 912 F.2d 1496, 1506 (D.C.Cir. 1990)). For instance, the *American Gas* Court wrote: *American Gas Ass'n v. FERC*, 912 F.2d 1496, 1507 (D.C. Cir. 1990) ("the potential impact of nonjurisdictional [sales] contracts' prices on the justness and reasonableness of jurisdictional rates provides no license for FERC to monkey with the former"), *cert. denied*, 498 U.S. 1084 (1991).

[23] *Id*.

[24] *Id*. at 1037, 1046.

[25] *Id*. at 1046.

[26] *Id*.

[27] *Id*. at 1045.

[28] *Id*. at 1043-44.

[29] 474 U.S. 409 (1986).

[30] *See Total TV v. Palmer Commc'ns*, 69 F.3d 298 (9th Cir. 1995) (drawing such distinction).

[31] 15 U.S.C. § 3431(c)() (2); House Conf. Rep. 95-1752, at 124 (1978), *reprinted in* 1978 U.S.C.C.A.N. 8983, 9041.

[32] *See FPC v. Louisiana Power & Light Co.,* 406 U.S. 621, 631 (1972) (refusing to create such a legal "no man's land").