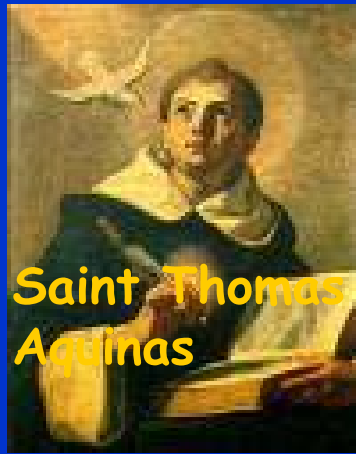


just prices and contracting

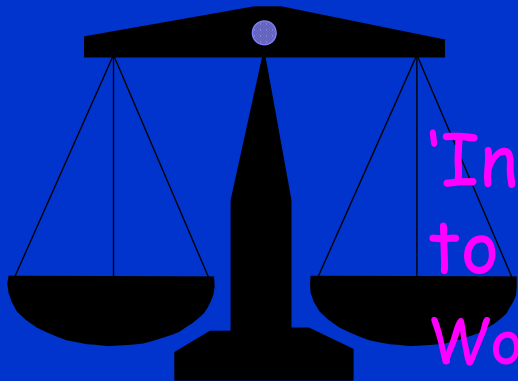
An update on a three millennium debate

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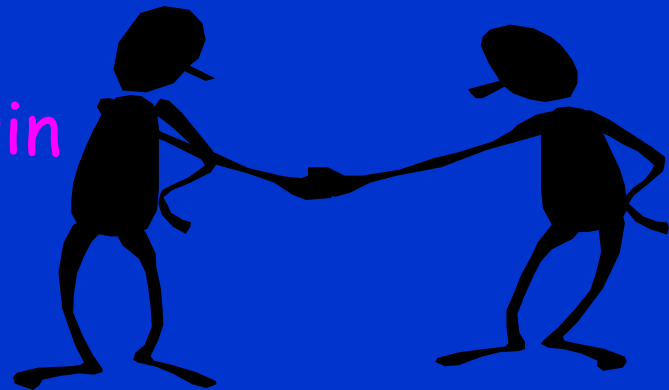
Harvard Electricity Policy Group
March 15, 2007

Views expressed are not necessarily
those of the Commission



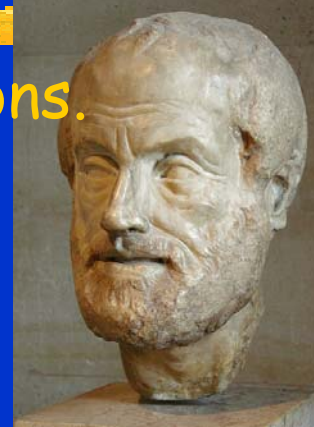
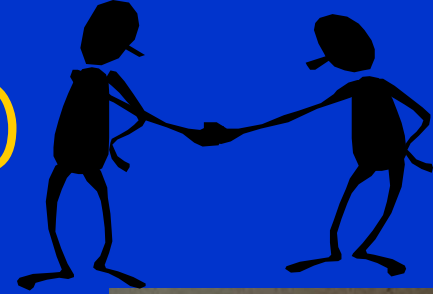
'In my family it was a sin
to pay retail'

Woody Allen to Annie Hall



The Just Price (*justum pretium*)

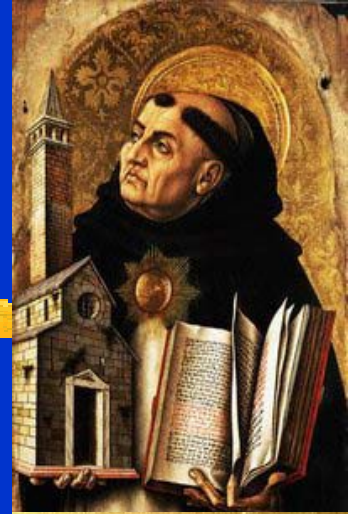
2300 years of debate



- ⇒ attempt to set standards of fairness in transactions.
- ⇒ 300 BC Aristotle in *Ethics* "Justice in exchange"
 - ☞ The just exchange ratio of goods (the just price) should be in proportion to their "intrinsic worth" to men.
 - ☞ Peoples' needs are different and usefulness varies
- ⇒ 100 AD Pax Romana Roman law was flexible:
 - ☞ price is "just" if it was agreed to by the contracting parties
 - ☞ Everything for sale
- ⇒ 1200 Thomists attempt to reconcile Aristotle and the Bible.
 - ☞ originally interpreted as the "intrinsic worth" of goods (*bonitas intrinseca*) as the order of appearance in Genesis.
 - ☞ Problem: rats are of higher Biblical order than wheat,
 - ☞ Eventually returned to Aristotle's usefulness
 - ☞ justifies why goods should be allowed to exchange at different prices in different places and times.

Christian schools of thought

What would Jesus do?



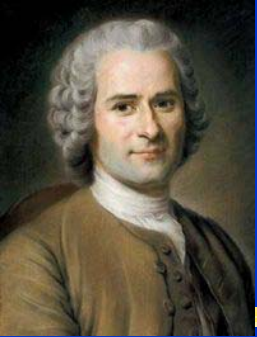
- ⇒ Dominicans and Jesuits: the "just price" was essentially price set in a free market. Aquinas
- ⇒ Franciscans: the just price equals the cost of production plus a reasonable profit. Scotus
- ⇒ Protestants: the fair price is the "natural" price where the "amount of labor exchanged in each good is the same." Calvin

Franchised Monopolies

Royal Charter



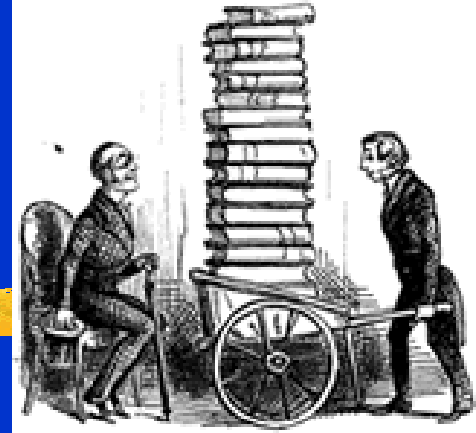
- ⇒ given by a sovereign (monarch) to legitimize an incorporated body, such as a city, company or university
- ⇒ UK: the BBC, Royal Opera House, Livery Companies, professional institutions, guilds and charities.
- ⇒ Often a franchised (unnatural) monopoly
- ⇒ Precursor of copyright and patent



Rousseau v Smith

- ⇒ 1762 Jean-Jacques Rousseau, *The Social Contract, Or Principles of Political Right*
 - ☞ The Social Contract is an implicit agreement within a state regarding the rights and responsibilities of the state and its citizens
 - ☞ when contract failings are found, we renegotiate to change the terms, using methods such as elections and legislature
 - ☞ Not a commercial contract
- ⇒ 1776 Adam Smith *the Wealth of Nations*
 - ☞ self-interest alone can lead to socially beneficial results,
 - ☞ but 'sympathy' (altruism) is also required (*Moral Sentiments*)

Commercial Contract



- ⇒ promises that the government will enforce.
- ⇒ mainly governed by state and common (judge-made) law and private law.
- ⇒ Private law includes the terms of the agreement between the parties who are exchanging promises
- ⇒ The law provides remedies if a promise is breached
- ⇒ a promise must be exchanged for adequate consideration.
- ⇒ Theory of Optimal Breach: reputation costs v. value of breach

Several ways to leave your Contract



- ⇒ Lack of Consideration
- ⇒ Invalid Offers
- ⇒ Invalid Acceptance
- ⇒ Lack of Performance
- ⇒ Defective Products
- ⇒ Frauds
- ⇒ Impossible Performance
- ⇒ Frustration of Purpose
- ⇒ Misrepresentation
- ⇒ Unconscionable Contracts
- ⇒ Intoxication

- ⇒ Duress
- ⇒ Mental Disability
- ⇒ Meeting of Minds
- ⇒ Force Majore
- ⇒ Illusory Promise
- ⇒ Violation of Public Policy
- ⇒ Violation of Law
- ⇒ Violation of Terms
- ⇒ Condition Precedent
- ⇒ Bankruptcy
- ⇒ Counterclaim



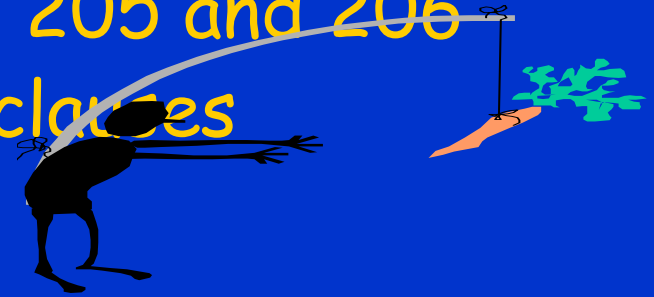
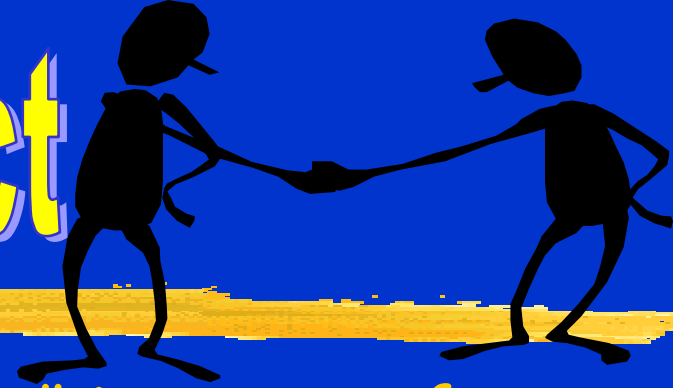
Federal Power Act (1935) and Natural Gas Act (1938): debate only 70 years old



- ⇒ Just and reasonable rates are a balance between
 - ⇒ Market power rents and
 - ⇒ Confiscation
 - ⇒ Not an exact (slide rule) process
- ⇒ Fix unjust and unreasonable rates
- ⇒ No Undue discrimination
- ⇒ if everyone is better off due discrimination
- ⇒ Public interest
- ⇒ Contracts
- ⇒ Certificates (NGA) and Mergers (FPA)

The regulatory compact

- ⇒ franchise or long-term “contract” in return for cost-of-service regulation
- ⇒ Often in return for cost-of-service regulation
- ⇒ Contract uncertainty: sections 205 and 206
- ⇒ price uncertainty/ “Memphis” clauses
- ⇒ weak or wrong incentives
 - ⇒ cost recovery assurance
 - ⇒ excessive costs
 - ⇒ over-investment/stranded costs
 - ⇒ excessive risk aversion/over insurance
- ⇒ too much reliability



Interstate Commerce Act (1887) v Federal Power Act (1935)



- ⇒ Interstate Commerce Act: uniform tariff requirements
 - ⇒ FPA and NGA contemplated individually negotiated contracts.
 - ⇒ NGA and FPA have two asymmetric standards
 - ⇒ Sec 205 and 206 have different thresholds
 - ⇒ It is end result that counts
- FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944)

Supreme (Warren) Court in the 1950s



- ⇒ Backdrop is cost-of-service regulation
- ⇒ Supremes were asked if a rate was too low

- ⇒ United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332 (1956)

- ⇒ FPC v. Sierra Pacific Power, 350 U.S. 348 (1956)

- ⇒ contract terms that justify intervention

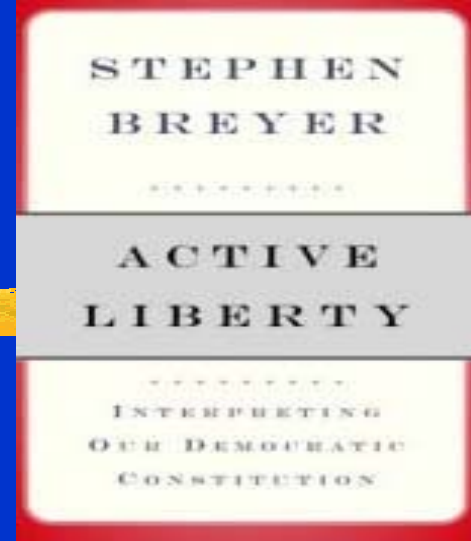
- ⇒ might impair the financial ability of [a] public utility from continuing its service (Chapter 11)

- ⇒ cast upon an excessive burden on consumers not party to the contract

- ⇒ or be unduly discriminatory. (*Sierra*).



Judicial Activism?



- ⇒ Supremes create a two-level rule-of-reason standard under 205 and 206
 - ⇒ With elastic modifiers "excessive" and "undue",
 - ⇒ the public interest intervention is harder than just and reasonable and the "public interest"

Mobile-Sierra Doctrine

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"The paper and ink content is within acceptable norms, but the contract itself appears to have too many clauses."

- ⇒ supposedly decreases contract uncertainty
- ⇒ By raising the standard for what constitutes the public interest in the context of FPA and NGA
- ⇒ the Commission can always find the contract was unjust, unreasonable, or unduly discriminatory.
Richmond Power and Light Co. v. FPC, 481 F.2d 490 (D.C. Cir. 1973)
- ⇒ Is this saying no strict cost-of-service review?

Memphis Clause United Gas Pipeline Co. v.

Memphis Light, Gas and Water Div., 358 U.S. 103 (1958),

- ⇒ Could a contract that specifically left the price term open be unilaterally changed.
- ⇒ contracts with provisions to change the rate during the contract term would be valid contractual authority to make a unilateral rate increase filing. *Pennzoil Co. v. FERC*, 645 F.2d 360, 374 (5th Cir. 1981).
- ⇒ Most gas pipeline contracts have Memphis clauses

Just and reasonable rates include market-based rates



- ⇒ Comm. was not bound to any single formula or combination of formulae in determining rates. *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 592, 593 S., 62 S.Ct. 736, 745, 746 Also *Mobil Oil Exploration v. United Distribution Co.*, 498 US 211, 224 (1991).
- ⇒ "when there is a competitive market the [Commission] may rely upon market-based prices in lieu of cost-of-service regulation" *Elizabethtown Gas Company v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993). *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1004 (D.C. Cir. 1990). *Consumers Energy Company v. FERC*, 367 F.3d 915, 923 (D.C. Cir. 2004).
- ⇒ With market-based rates and mitigation, basic finding is market power is in balance
- ⇒ Do we need to Feng Shui the FPA?

風水

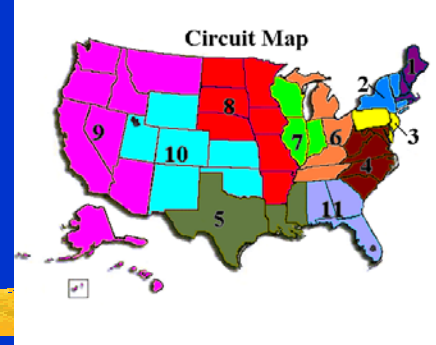
"Feng Shui"

El Paso's contracts



- ⇒ under *Mobile-Sierra*, the Commission
 - ⌚ found changes to market conditions had rendered the settlement out of date
 - ⌚ deprived California consumers of adequate gas supplies.
 - ⌚ found that the public interest was being adversely affected by the contracted settlement and
 - ⌚ converted full requirements to contract demand arrangements *Arizona Corp. Comm v. FERC* (2005)
- ⇒ the orders meet the *Mobile-Sierra* public interest standard.
- ⇒ The Commission exercised its *Mobile-Sierra* authority to prevent “the imposition of an excessive burden” on third parties. *Northeast Utils. Serv. Co. v. FERC*, 55 F.3d 686, 691 (1st Cir. 1995)

Ninth Circuit on Western Energy Crisis Contracts



- ⇒ determines that the *Mobile-Sierra* standard of review should apply only when :
 - ⇒ the contract must not preclude the limited *Mobile-Sierra* review;
 - ⇒ the regulatory scheme must provide FERC with an opportunity for effective, timely review of the contracted rates; and
 - ⇒ For market-based rates review must consider all factors relevant to the propriety of the contract's formation. *Public Utility District No. 1 of Snohomish County Washington v. FERC*, and *Public Utilities Commission of the State of California v. FERC* (2006)
- ⇒ FERC must have mechanism for responding in a timely manner to market abnormalities that affect agreements,
- ⇒ conduct an inquiry of broad scope when examining the circumstances of contract formation
- ⇒ doctrine will not apply to contracts executed in markets that are not "sufficiently well-functioning."

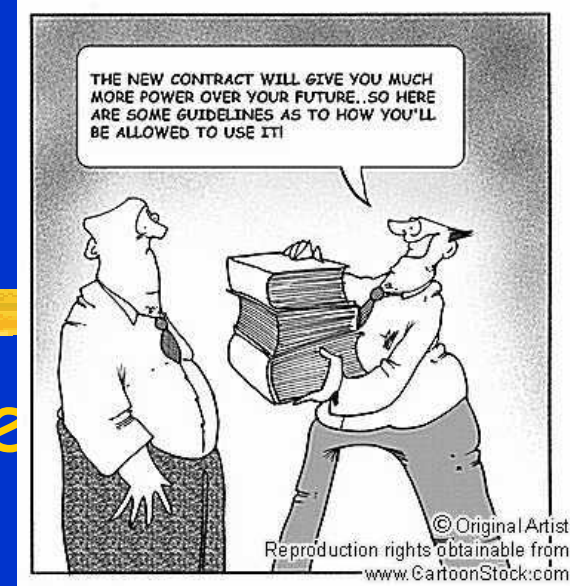
Market based rates in ISOs was it contemplated in the 1950s?



- ⇒ California has always been on the cutting edge
- ⇒ Sometimes bloody
- ⇒ MBR starts in the late 1980s in California
- ⇒ Still on the learning curve
- ⇒ Competition paradigm was debated in the EPAct 05
 - ☞ Passionate
 - ☞ Hyperbolic
- ⇒ Ex post v ex ante mitigation in ISOs
- ⇒ Ex ante: conduct and impact test
 - ☞ satisfies 'consider all factors' and 'broad scope'
 - ☞ satisfies 'timely review'

Economics of Contracts

Oliver E. Williamson, Transaction Cost Economics



⇒ Contracts inherently incomplete

⇒ Benefits of contracting

- ⇒ Mitigated opportunism, e.g., market power

- ⇒ Risk management: hedge real-time market

⇒ Costs of contracting v. spot market

- ⇒ Search and information costs

- ⇒ Bargaining costs

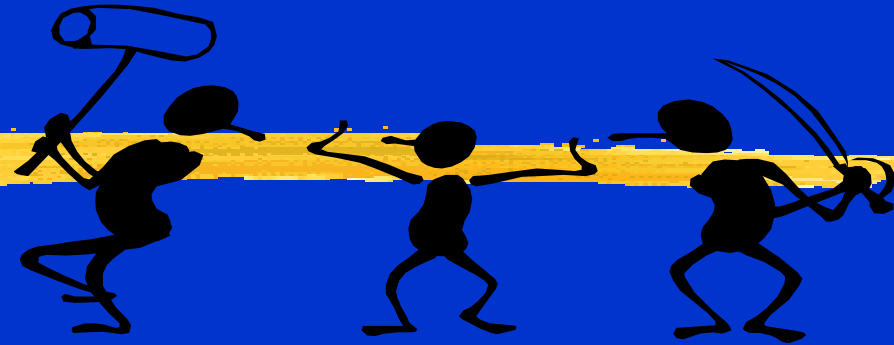
- ⇒ Policing and enforcement costs

- ⇒ Allows for rational ignorance

- ⇒ Lower transaction costs in the real-time market



Now IRP with a new wrinkle: competition



- ⇒ The MS Sword is double edged
 - ☞ Munis want long term contracts
 - ☞ Why have long-term contracts if FERC can easily change them
- ⇒ Without strong contract rules
 - ☞ cost of long-term contracting increases
 - ☞ Risk of intervention increases
 - ☞ More incompleteness
- ⇒ With strong contract rules
 - ☞ cost of long-term contracting decreases
 - ☞ Risk of draconian intervention decrease
 - ☞ Less incompleteness
- ⇒ Irony: Some groups that desire long-term contracts in lieu of spot markets are those supporting intervention

Coase on market design

'Stock and produce exchanges are often used by economists as examples of perfect or near-perfect competition. But these exchanges regulate in great detail the activities of traders (and this quite apart from any public regulation there may be). What can be traded, when it can be traded, the terms of settlement and so on are all laid down by the authorities of the exchange. There is, in effect, a private law. Without such rules and regulations, the speedy conclusion of trades would not be possible.'

Ronald H. Coase, Nobel Prize Lecture,
December 9, 1991