

Avoiding "Megalosses" in Drafting the Provisions of Electric Power Trading Contracts

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I. OVERVIEW OF THE ISSUES

This article addresses potential concerns for buyers and sellers in the electric power industry in the making and the performance of contracts involving the purchase and sale of electricity (both energy and capacity). Contracts are generally executed for two basic purposes: first, to make a profit, and second, to ensure certainty of the supply of goods and services. Unfortunately, changing market and regulatory conditions can alter the assumptions under which the parties entered into the contract. The result is often a situation in which one party decides that it is better to breach the contract than to perform. The nonbreaching party may be stranded with losses or must resort to litigation to enforce its contractual rights.

The electric power industry is changing at an ever-quicken pace: enormous market opportunities are being created by the Federal Energy Regulatory Commission's ("FERC") recent unbundling of transmission services, its allowances of open access in the wholesale market and the emergence of retail wheeling in a number of states.(1) The industry is quickly evolving. Unfortunately, rapid deregulation at both the wholesale and retail level as well as the frantic rush to gain market share may leave a trail of agreements in which the key terms are drafted with imprecision if the agreement is written at all.(2)

A key issue for parties drafting contracts for the purchase or sale of electric power will be the transition to a deregulated market environment. The growing wholesale and retail markets make these contract issues increasingly more important. Drafters can avoid many significant problems by learning from the lessons of the past deregulation of the natural gas industry. In Order No. 888, the FERC recognized that the agency "learned from ... [its] experience in the natural gas area the importance of addressing competitive transition issues early and with as much certainty to market participants as possible."(3) Drawing on the litigation experiences of the natural gas industry from the past decade, those engaged in the buying and selling of electric power can avoid some of the potential pitfalls and resulting losses (such as the "megalosses" in the billions of dollars from natural gas take-or-pay clauses(4)) with careful planning and policy decision-making.(5)

To examine these potential areas of concern in the electric power industry, this paper considers the following basic contractual terms: (a) price, (b) quantity, (c) duration, (d) force majeure, (e) defaults and remedies, and (f) choices of forum for dispute resolution and governing law. This list is not exhaustive. As the industry faces reduced federal and state deregulation, competition in the marketplace will dictate creative solutions to contract issues. Some fundamental provisions, however, should be considered in all contracts-whether short-term, intermediate or long-term-in order to avoid the possibility of future losses.

II. THE LESSONS OF HISTORY: THE NATURAL GAS CONTRACT EXPERIENCE

As the electric power industry rapidly changes through deregulation and increased market competition, the question arises: what lessons can be learned from the disastrous experience of natural gas litigation from the past several decades?(6) For those who lived through it, the answer seems simple enough: protect your position in the contracts you make, whether as a buyer, seller, or broker of electric power.(7) In implementing this philosophy however, power traders may feel a false sense of security. First, a power trader can examine the lessons of the natural gas experience and presumably eliminate any obvious contract deficiencies from the start. Second, unlike the natural gas industry during the 1970s and 1980s, deregulation is taking effect before power-trading contracts are going to be executed (at least at the retail level). Power traders can rest assured of a competitive wholesale marketplace via implementation of FERC Order No. 888, that will be enhanced by pending deregulation of the retail market by the states. This should substantially mitigate the difficulties natural gas pipelines experienced in the 1980s from take-or-pay clauses. Finally, electricity is simply different from natural gas. Once generated, it cannot be economically stored and will not wait for a delivery date under a contract. By this fact alone, it would seem that the ominous "take-or-pay" disaster of the 1980s can be avoided.

There are, however, several reasons to expect that at least some of the pitfalls which led to massive natural gas litigation may also await the power-trading industry. To begin with, although deregulation is increasing market opportunity, it is also creating contractual uncertainty. For example, although FERC Order No. 888 provides for open access by unbundling transmission services, it creates new issues such as multiple methods (under state or federal law) by which stranded generation costs may be recovered through transmission rates.(8) In addition, the FERC's Notice of Proposed Rulemaking ("NOPR") for the Capacity Reservation Tariff ("CRT")(9) released the same time as Order No. 888, could potentially result in a total change of the power-trading system currently in place. Instead of "load-based" network service, transmission of power would be accomplished through firm rights to capacity on electric transmission grids. In short, the power-trading industry, like the natural gas industry, will be subjected to constantly changing conditions based on regulatory changes at the federal and state levels.

What lessons can be learned in a changing environment in the power-trading industry from the natural gas experience? The lesson is not to deny the potential for

a recurrence of that phenomenon when drafting contract provisions. Buyers and sellers of electric power must carefully consider how each contract term may be affected by, or may account for, altered market or regulatory conditions. This is, of course, particularly important with respect to the key terms such as price, quantity, and duration. It would be foolish, however, to think that any drafting could perfectly anticipate the vicissitudes of the market, the legislature, and the regulator. Therefore, guarding the "back-door" in the key contract provisions is critical. Specific remedies must be crafted for the inevitable time when one party to a power-trading contract finds itself overwhelmed by opportunity or exigency, and decides simply to breach the agreement and take (or litigate) the consequences.

A. Losses Experienced in the Natural Gas Industry

During the 1970s and early 1980s, pipeline companies incurred massive take-or-pay risk.⁽¹⁰⁾ Take-or-pay provisions had been an integral portion of wellhead purchase contracts for years as the FERC, then required to regulate wellhead prices, attempted to encourage stability. To encourage exploration and production, the FERC changed the rates and then legislated themselves out of the wellhead pricing business altogether. The take-or-pay provisions required pipeline companies to pay for specified gas volumes (typically, a percentage of well deliverability) even if they could not sell the gas. Although these provisions first pertained only to a duration of one year or less, the duration terms were subsequently expanded to longer periods. The take-or-pay liabilities then began to materialize and grew to extraordinary levels. This growth was fueled by the fact that many pipeline companies were facing a situation where their sales and prices were rapidly declining. This forced these pipeline companies to realize that they would be unable to sell (or resell) the minimum gas volumes for which they were bound to purchase by long-term contracts.⁽¹¹⁾

The severe gas shortages during the 1970s led to the enactment of the Natural Gas Policy Act of 1978 ("NGPA") which, among other things, began deregulation of prices for most new gas and allowed for an increase in ceiling prices over those previously established by the FERC.⁽¹²⁾ To avoid future shortages, pipelines quickly entered into *long-term* take-or-pay contracts at the high prices made possible by the NGPA. Those high prices stimulated producers to greatly increase exploration and drilling.⁽¹³⁾ Unfortunately, by 1982, demand began falling and by 1983, demand for natural gas was drastically lower than in 1979.⁽¹⁴⁾ As a result, supply far exceeded demand throughout the remainder of the 1980s. By 1989, the FERC estimated in Order 500-H that pipeline companies had about \$44 billion in take-or-pay liability.⁽¹⁵⁾

The FERC issued its Order No. 500 in 1987 in order to allow pipelines to allocate their take- or-pay settlement costs among all of their customers.⁽¹⁶⁾ As a result, many pipelines renegotiated their contracts as soon as possible by agreeing to pay the producers some fraction of their potential claims. Unfortunately, these negotiations took place in the context of FERC Order 380, which prohibited the passing of settlement costs on to pipeline customers.⁽¹⁷⁾ Five years later, the FERC issued Order No. 636 to unbundle transportation services and to stimulate competition.⁽¹⁸⁾ This required the pipelines to provide transportation services on an

equal basis for all supplies regardless of where the gas supplies were purchased.(19) This process may be contrasted with the FERC's Order No. 888 which at the same time requires open access to electric transmission facilities and allows electric utilities to allocate their stranded costs (incurred due to loss of customer load from competition) among wholesale customers.

B. A Review of Inherent Problems in Natural Gas Contracts

It would be an oversimplification to attribute \$44 billion of contractual liability to the mere fact that take-or-pay provisions were in the contracts.(20) We submit instead that the difficulties of the 1970s and 1980s were created by problematic drafting of the contracts and a lack of flexibility in the agreements to deal with instability (such as market change or deregulation). As explained by Justice Bowman of the United States Court of Appeals for the Eighth Circuit:

The damages issues raised by the parties are complex. They arise against a backdrop of government regulation, and grow out of ambiguous and otherwise unclear provisions in contracts between the parties for the purchase and sale of natural gas at prices that ceased to reflect market conditions once Congress' partial deregulation of the natural gas industry in the 1980s had turned a shortage of natural gas into an abundant supply.(21)

Take-or-pay provisions often required pipeline companies to purchase gas at high prices that were tied to the escalating price provisions provided for by the NGPA.(22) Unfortunately, under the provisions of FERC Order No. 380, the pipelines had no ability to pass on to their customers the costs for gas that was paid for but not taken.(23) The FERC tried, partially and belatedly, to patch-up the take-or-pay disaster by Order No. 636 that allowed natural gas pipelines to recover some of their losses through "transition costs."(24) This was too little, too late for many contracting parties. In addition to the obvious price and quantity difficulties of take-or-pay provisions, the contracts also contained duration terms that stretched the performance dates up to many years.

When confronted with long-term take-or-pay problems, a natural gas pipeline had four alternatives:

- (1) buy-down the high contract prices per Mcf of gas and continue to perform under this lower price term;
- (2) buy-out the contract completely and fulfill its obligations to customers through purchases at the lower market prices for gas;
- (3) breach the contract through anticipatory repudiation and resolve the matter through settlement or litigation; or
- (4) do nothing.

Some natural gas pipelines chose the last alternative. They reasoned that as long as

they were not tendered any high-priced gas under the contracts (often from small, independent producers who did not have high delivery capacities), there was simply no take-or-pay problem. Thus, short-term reasoning failed when, years later, these contracts were assigned by small, independent producers who were nonetheless astutely aware of the contractual rights, to big producers that had the capacity to deliver huge volumes of natural gas to the pipelines. The contracts' duration terms often stretched their performance into the mid-1990s. Since many of these agreements also contained open-ended quantity provisions, the amount of gas tendered for delivery was astounding. The result was a new round of litigation on several issues: whether the contracts were subject to limitations on good-faith delivery of product and whether such contracts were freely assignable.

Recent court decisions have firmly brought home the lesson that a contract of lasting duration with an open-ended delivery provision may lead to disastrous results. For example, in 1996 the Texas Supreme Court in *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*(25) considered a claim under such a contract and found that the take-or-pay provision was still viable and not subject to Section 2.306 of the Uniform Commercial Code that puts a limit on output contracts. These scenarios obviously can lead companies to lose significant, if not overwhelming amounts, of money through litigation and settlements. Whether the electric industry will remember these lessons and profit from them is yet to be seen.

III. THE POTENTIAL FOR "MEGALOSSES" IN THE ELECTRIC POWER INDUSTRY

History need not be repeated if the lessons learned from the natural gas experience are proactively applied to meet the challenges that will confront buyers and sellers in the emerging electric power-trading industry.

A. Structure of The Current Marketplace

The electricity sales industry is one of the largest in the country, yielding annual revenues of approximately \$200 billion.(26) To put the industry in perspective, it is roughly 3.2% of the gross domestic product or triple the size of the local and long-distance telecommunications industry.(27)

Power marketers are a new entrant into this large, growing industry. Before 1992, the sale of electricity was heavily regulated. Since 1978, competition in the electric generation market had grown dramatically under the protection of the Public Utility Regulatory Process Act of 1978 ("PURPA"), which protected certain "Qualifying Facilities" from retaliation by traditional utilities, and required those utilities to buy power from the Qualifying Facilities.(28) But the passage of the Energy Policy Act of 1992 ("EPACT") dramatically relaxed some of the restrictions on the transmission services market.(29) One of EPACT's key provisions guaranteed sellers of electricity the right to access transmission lines that did not belong to them so they could deliver power to wholesale customers in distant locations. At the same time, FERC determined to allow all applicants who did not otherwise have the ability to exclude others from the electric power market, to sell power at

market-based rates, rather than FERC-set rates. As a result of these bold steps, companies of all kinds requested permission to participate in the markets. Gas marketers, utility affiliates, commodity brokers, and even investment banks went to the FERC for certification as power marketers.(30) This certificate allows the holder to buy and sell electricity at market-based prices; that is, whatever price the parties to a deal agree upon.

By mid-1994, the number of active power marketers grew from eight to fifty-two.(31) Since then, the number has doubled every year.(32) In 1996, there were 166 power marketers licensed by FERC and, by March 1997, there were 284 licensed marketers (over a 71% increase).(33)

Power marketing sales also grew rapidly. During the first half of 1996, power marketers cumulatively sold 65.5 million MWh, more than doubling the sales of 28 million MWh that they had experienced during all of 1995.(34) By the second quarter of 1997, total sales rose to 216 million Mwh.(35) Still, the recent boom in power sales only accounts for 1.4% of all wholesale electricity sales, which stood at about 1.9 billion MWh in 1995.(36) The potential wholesale market is valued at approximately \$90 billion.(37) Much of that market could open-up in the next three to five years, as long-term utility supply contracts with other utilities and non-utility generators expire.(38) But the retail market, estimated at \$110 billion, shows the most potential as states begin to adopt programs that open it up to competition.(39)

The ever-growing market is demonstrated by charting the sales of the top ten marketers in the past few years:

Company	1995 Sales (MWh)	Company	1996 Sales (Mwh)	Company	1997 through 2nd Qtr. Sales (MWh)
Enron Power	\$7,880,704	Enron Power	\$59,723,290	Enron Power	\$36,757,620
Louis Dreyfus	4,294,458	Louis Dreyfus	28,303,534	Electric Clearinghouse	16,342,031
Electric Clearinghouse	3,573,142	LG&E	17,075,223	VITOL	12,475,786
Citizens Lehman	1,937,532	Electric Clearinghouse	14,627,509	Louis Dreyfus	12,093,051
CATEX	1,175,003	VITOL	10,005,546	Southern Energy	10,621,203
R.J. Dahnke	1,127,492	KOCH Power Source	9,963,860	LG&E	9,724,519
NAEC	840,306	AQUILA	6,726,504	ILLINOVA	9,986,208
CNG	820,477	CNG	4,880,360	Engage	7,528,230

				Energy (formerly Coastal)	
NORAM	554,368	PAN ENERGY	4,239,391	Energy Power Mktg.	7,298,161

The chart reveals that at this early stage of development, some of the strongest players in the business are longtime players in the oil and gas industry. The chart also makes it clear, however, that the industry is continually evolving as new players enter the wholesale and retail markets.

B. Standard Contract Practices in The Wholesale Market

For practical purposes, competition in the electric industry has been limited to the wholesale market.(40) Recent changes have allowed the wholesale market to begin developing its own trading systems and exchanges for selling power. FERC Order Nos. 888 and 889, which opened up transmission lines to electric power wholesalers, also created an electronic information system, Open Access Same-Time Information System ("OASIS"), that is designed to provide data regarding transactions such as purchases and sales of transmission service from utilities or in secondary markets.(41) The growth of the wholesale trading market has been phenomenal since the passage of these key FERC Orders.(42)

The growth is not without concerns. Many power marketers claim that the market is dominated by a few megatraders and that the rest are not making money. In some cases, smaller power marketers are simply trying to position themselves in the market to be able to participate when competition in the electric generation market becomes more widespread through industry restructuring and divestiture. Many also complain that the current market has little liquidity.(43) Moreover, many players have complained that OASIS is deficient, if not defective. Thus, power traders without their own generation must protect their financial position by "mirror matching" sellers with buyers to take physical delivery.

Other, less-apparent problems exist in the vehicles used to make trades. Sales of electric energy are made through a variety of contractual arrangements that are analogous to commodities trading.(44) However, there are some unique characteristics to power trading. For example, electricity cannot be stored. Thus, marketers must purchase capacity, which is itself akin to an option. Unfortunately, no standard contracts exist that account for the unique requirements and characteristics of power trading. Contract terms are often left open or ambiguous by eager players in an effort to facilitate trading in an illiquid market.(45)

C. The Stranded Costs Issue: Potential Losses to be Borne By Buyers and Sellers

Stranded costs refer to a utility's investment in its generating capacity (e.g., its generating plants as well as transmission and distribution facilities) that makes it too expensive for the utility to sell power profitably in a competitive market.(46) In an effort to recoup some of these stranded costs, utilities may impose "exit fees"

upon customers who choose to leave the utility and get their power from an alternate supplier.(47) Although FERC and some states have enacted legislation that allows utilities to recover stranded costs, each has different provisions for recovery. In addition, not all commentators agree that stranded costs should be recoverable. For instance, some commentators argue that the utilities certainly anticipated deregulation, that such indemnification was not forthcoming in prior deregulated industries, and that it should not be allowed now.(48) Others argue that stranded cost recovery leads to the dichotomous supposition that the greatest protection will be afforded to those utilities that made the poorest investment decisions.(49) Still other commentators argue that stranded cost recovery should be allowed only on a case-by-case basis, if at all, and not allowed based on the presumption that all utilities will experience such costs.(50) Despite the industry dissent regarding the issue, FERC and nearly all the investor-owned utility commentators endorse the proposal of allowing stranded cost recovery.(51)

1. Stranded Cost Recovery Under FERC Order No. 888

In May 1996, the FERC issued Order No. 888: Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services and Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities. Under Order No. 888, the FERC allows utilities to recover stranded costs from their former customers so long as the costs are "legitimate, prudent, and verifiable" and consistent with a utility's "reasonable expectations" of continuing to serve its client.(52) For example, Order No. 888 allows both utilities and customers to ask the FERC to convert their existing requirements contracts into transmission capacity rights. Although former holders of requirements contracts may no longer wish to get their requirements from a high-priced utility and may wish to find a cheaper source, they will still have to use the utility's transmission lines to bring the cheaper power to their facility. Thus, the utility seeking to recover its stranded costs or the customer who feels it is being charged a disproportionate amount of stranded costs may ask the FERC to retroactively modify the old requirements contract and impose a fee that is more just.

The details of stranded costs recovery under Order No. 888 are as follows:

NEW CONTRACTS: All wholesale contracts executed after July 11, 1994, are considered new contracts.(53) Unless these contracts contain an express provision allowing the recovery of stranded costs (including a formula for calculating these costs), no recovery will be allowed.(54)

EXISTING CONTRACTS: A utility may file to recover stranded costs on "existing" wholesale contracts (those executed on or before July 11, 1994) if the parties cannot renegotiate to add such a provision in the contract.(55) The party seeking to modify the contract still has the burden to show that the contract is no longer "just and reasonable."(56) A utility may not recover stranded costs for existing wholesale contracts, however, if there is a provision explicitly prohibiting recovery.(57) Also, if a transmission or a power tariff filed by the FERC prohibits recovery of stranded costs, this too will prohibit any recovery by the utility.(58)

METHODS OF COST RECOVERY: There are three methods of recovering stranded costs in a qualified existing requirements contract:

- i. The parties may mutually renegotiate their contract, agree on a method of dealing with the stranded costs, and file the revised contract with the FERC(59);
- ii. Either or both parties may seek to amend the contract before it expires, even if the contract itself forbids the right to challenge the contract so long as no clause expressly forbids stranded cost recovery (60) ; or
- iii. The utility presently supplying power under a wholesale contract may file a request with the FERC, before the existing contract expires, to recover stranded costs through a future surcharge on its transmission rates for that customer.(61)

The FERC has exclusive jurisdiction over interstate transmission, including the transmission of electricity for retail sale (*i.e.*, retail wheeling) that local regulatory authorities have unbundled from distribution and made subject to competition.(62) Order 888 directly regulates only entities that are under the FERC's jurisdiction (*e.g.*, the nation's public utilities(63) and certain power pools(64)). The FERC, however, can indirectly regulate utilities that are not under its direct jurisdiction.(65) For example, Order No. 888 imposes reciprocity requirements that require public utilities within a state to allow the use of their transmission service and to offer the same quality of service as utilities under the FERC's direct jurisdiction.(66) This reciprocity is a condition that state-jurisdiction utilities must meet to be eligible to take advantage of open-access transmission by FERC-regulated utilities.(67) Once they meet the condition, retail customers and their suppliers within that state are eligible to apply for and obtain transmission service under Order No. 888's open-access transmission tariffs.(68)

2. State Solutions for Recovery of Stranded Costs

Different states are taking a variety of approaches to allow utilities under their jurisdiction to recover stranded costs. The following states provide a broad sampling of the methods by which states are providing for the recovery of stranded costs.

CALIFORNIA: As of January 1, 1998, California will impose a "non-bypassable" exit fee called the Competition Transition Charge ("CTC") on utility customers departing because of cheaper rates elsewhere.(69) The CTC is designed to recover the approximately \$22 billion incurred by the state's investor owned utilities.(70) However, the January implementation date was initially delayed until March 31, 1998 because of computer problems with the new software that links the state's electricity transmission operating system and distribution network.(71) The CTC will only be imposed over the transition period during which the state will adopt retail wheeling.(72) The new legislation has also guaranteed a 10% rate reduction

for residential and small commercial customers beginning on January 1, 1998,(73) and a cumulative rate reduction of at least 20%(74) beginning April 1, 2002. Finally, customers can exempt themselves from the CTC by building their own cogeneration plant.(75)

The California Public Utility Commission recently approved \$7.3 billion in bonds to finance a rate reduction for residential and small business customers beginning January 1998.(76) Those customers will repay the bonds during the time period from the year 2002 until the year 2008 as their portion of "competition transition charge" that the utility companies will charge all its customers during the time period from the year 1998 until the year 2002 in an effort to recoup stranded costs.(77)

RHODE ISLAND: On August 7, 1996, Rhode Island passed its Utility Restructuring Act which will permit retail wheeling by July 1, 1998.(78) Rhode Island will permit the recovery of stranded costs through a "transition charge" that will be assessed over a twelve-and-one-half year period (from July 1, 1997 through December 31, 2009).(79) The charge will be 2.8 cents/kWh through December 31, 2000 and will be adjusted by the Rhode Island Public Utilities Commission thereafter.(80)

The Act also requires utilities to divest generating facilities. Each Rhode Island public utility must file a plan for transferring ownership of generation, transmission, and distribution facilities into separate affiliates by January 1, 1997.(81) The utilities, however, will continue to provide a "standard offer" at current prices adjusted for inflation through 2009 to protect those customers who do not wish to switch companies.(82)

PENNSYLVANIA: On December 3, 1996, Pennsylvania enacted legislation deregulating the electric industry and phasing in retail competition.(83) The phase-in begins in January 1999 and culminates in full customer choice by 2001.(84) The Pennsylvania law allows for the recovery of stranded costs via a competitive transition charge over a period of up to nine years.(85) The law also allows utilities to issue transition bonds to help them recover stranded costs.(86) The law requires "rate caps" on utility charges to customers during the transition period.(87)

Under the Pennsylvania plan, utilities will not be guaranteed 100% recovery of their stranded costs. The Pennsylvania public utility commission will determine what amount of a utility's stranded costs may be recoverable because they were "[p]rofitably incurred, . . . [and] generally recoverable in a regulated industry but potentially nonrecoverable in [a] competitive generation marketplace."(88) Thus, the utility commission will attempt to distinguish between stranded costs that resulted from poor management and those that resulted from valid regulatory requirements.

MASSACHUSETTS: Like Rhode Island, Massachusetts has proposed a plan that requires utilities to recover stranded costs by divesting themselves of generation assets at market value by the year 2001.(89) The plan would only allow utilities to recover stranded costs after they sell off their portfolio of generation assets to the

highest bidder.(90) The plan has no stranded cost recovery provisions for utilities that do not sell their generation assets.(91) This recovery plan does not rely on forecasts and has the distinct advantage of creating firm stranded cost numbers.

TEXAS: The Texas legislature introduced the state's most recent power restructuring plan during its 1997 legislative session. The bill provides that stranded cost recovery should be calculated as the difference between the value of all the utility's power generation assets that have a book value equal to or greater than market value; and the value of those assets that have a book value less than market value.(92) The bill also required the utility seeking to recover stranded investments to "aggressively mitigate any uneconomic investments."(93) This potentially would have allowed Texas utilities to recover billions of dollars of stranded costs especially those associated with HL&P's South Texas and Texas Utilities' Comanche nuclear plants.(94) The proposed bill required that the utility's shareholders and customers share stranded cost recovery equitably but disallowed the use of exit fees unless the departing customer agreed to pay such a fee.(95) Unfortunately, the deregulation bill collapsed in the 1997 Texas Legislature, so the next opportunity to consider power deregulation will have to be examined when the Legislature reconvenes in 1999.(96)

VERMONT: The Vermont plan would allow utilities to recover stranded costs through state issued bonds backed by transmission "wire charges" that will apply to all customers that use transmission lines (as opposed to strictly local distribution lines) to receive their electricity.(97)

3. Practical Implications of FERC Order No. 888 and State Regulations

State solutions may conflict with FERC Order No. 888. Thus, power purchase agreements should clearly include detailed treatment of future stranded costs to avoid unexpected increases in the cost of power from regulated allocation of stranded costs. Parties to the contracts must first consider factors such as the outside regulatory forces that may affect their pricing structure for power. For example, a utility subject to the FERC's jurisdiction should evaluate its individual contracts to determine whether it is a "new contract" (*i.e.*, one that is dated after July 11, 1994) or an "existing contract" (*i.e.*, one dated on or before July 11, 1994). It should then evaluate methods of cost recovery (or cost avoidance) available using methods such as (1) renegotiation of the contract between the parties, (2) amending the contract, or (3) requesting a surcharge on transmission rates. Similarly, parties that are subject to the jurisdiction of a particular state's regulators should evaluate the state-specific requirements and tariffs. For example, Oklahoma and Oregon have begun investigations into restructuring their electrical industries.(98) The Texas legislature has also passed a bill that substantially deregulates the Texas wholesale market but does not address retail wheeling.(99) In light of the expanding wholesale and retail markets, traders are well-advised to consider the jurisdictions in which they trade, re-evaluate their existing contracts, and take affirmative steps to efficiently structure new contracts to reap the benefits (or avoid the pitfalls) of deregulation.(100)

D. Risks Inherent in Both Wholesale and Retail Market Contracts

There is a tremendous amount of uncertainty inherent in power trading. For example, there are seemingly countless buyers and sellers(101) as well as a large variety of potential transactions. In addition, power traded in one state can ultimately wind up being transmitted to an end-user in another state. As each state imposes different regulatory requirements for the implementation of retail wheeling, contracts must reflect the unique issues raised in every state. Thus, arising from the increased competition and market opportunity, there is also a high potential for variation among different contracts as well as key provisions in a single agreement. The best means to avoid losses is to consider the long-term impact of the fundamental terms in a contract upon the seller or buyer.

The main areas of risk inherent in power-trading contracts will be similar to those which caused difficulties in the natural gas industry: price, quantity, duration, force majeure, defaults and remedies, choices of forum, and choices of law. For example, in determining price, parties must consider multiple issues such as:

- i. how will the risk and cost of stranded costs be borne between buyers and sellers in power-trading contracts;
- ii. what constitutes a stranded cost-
- iii. how do changing regulatory requirements impact the price terms of an existing contract; and
- iv. what constitutes a reasonable price for electricity -- is it a price quoted by the New York Mercantile Exchange ("NYMEX") futures contracts price, informal price quotes from market leaders in electric power trading, or other contract prices implemented by buyers and sellers?

The impact of such considerations will be wide-spread to players in the industry. As large-scale industrial users attempt to lower their production costs by renegotiating their cost of electricity, they will necessarily reshape their contracts for power and face new issues relating to these contracts. Although power traders in the wholesale market are gaining experience on a daily basis, they will also be faced with new contract issues (along with competitive markets) with the opening of industrial and retail markets.

E. Power Trading Contracts: Avoiding The "Efficient" Breach

For a buyer or seller of electricity, the main goal of a contract is to make a profit and establish certainty of supply. From a legal perspective, however, a contract is viewed in a different way. Ironically, the law defines contracts more in terms of their breach than in terms of their execution by the parties.(102)

In the emerging power-trading industry, there will be two competing interests in every contract: a desire to avoid losses from risk and a desire to incorporate flexibility into the terms of the contract. Unfortunately, these two calculations are

different depending upon whether the party is a buyer or a seller. A buyer (such as a large-scale industrial user or municipality) may consider certainty and risk avoidance as more important than flexibility. While such a buyer may wish to lower its energy costs, it also wants to ensure a stable, steady supply of electricity in order to avoid losses from power outages. A seller, on the other hand, has an incentive to maximize the price received for the power, possibly through flexible pricing provisions that ensure that its cost in obtaining power from a third-party supplier will not be greater than the contract price it receives from the buyer.(103)

In drafting future power-trading contracts, the question thus becomes how to balance the competing interests of buyers and sellers. For example, short-term contracts at variable prices introduce an element of risk that many end-users may not be willing to bear. On the other hand, long-term contracts at set prices will reduce risks of supply interruption but will increase the risk of losses from market or regulatory changes. Long-term contracts also increase the risk of an "efficient breach" if market conditions make performance under the contract uneconomical.(104) Such practices were illustrated in the natural gas industry when a pipeline faced with a take-or-pay contract for a fixed quantity at an above market price had little option other than to either buy-out (or buy-down) the contract or simply breach it.(105) Thus, if a natural gas purchaser felt that it would be less costly to repudiate the contract with the producer as seller and refused to perform, it was "efficient" to breach the contract. The buyer then purchased gas on the market at lower prices and hoped that the costs of litigation were less than the cost to perform under the agreements. With rare exceptions,(106) the pipelines were ultimately required to pay liquidated damages under the contracts.

Currently, power contracts are usually short-term or intermediate-term and reference individual "pricing agreements" that require the buyer and seller to nominate price and quantity on a continually revised basis.(107) In the current market, there appears to be little incentive to negotiate long-term (or even intermediate-term) contracts.(108) Power traders must focus on the daily swings in the market rather than on the securing of long-term supplies of electric power. These power traders do, however, have an incentive to gain long-term market share. Also, as retail wheeling becomes available, end-users may have more incentive to negotiate longer-term contracts in order to eliminate supply uncertainties or market-wide price swings.(109) These alternative, speculative scenarios mean only one thing: no one can say with certainty what the power market will look like in the near or longer term future. All of these possibilities should be a reminder to attempt to eliminate market and regulatory uncertainty from future contracts.

IV. ELECTRIC POWER CONTRACT TERMS AND CONDITIONS: HOW TO AVOID "MEGALOSSES"

This section reviews the fundamental terms of power-trading agreements in light of the litigation that resulted from the past problems that plagued the natural gas industry. While the issues regarding power-trading contracts will remain unclear until the wholesale and retail markets become truly competitive, consideration of several of these issues may prevent future problems for the buyers and sellers of

electric power.

A. Price Provisions

Although deregulated sellers of electricity often promise potential cost savings in comparison to traditional utilities, powertrading contracts often allocate transmission costs and other miscellaneous expenses to a single party, usually the buyer.(110) In fact, such contracts often expressly state that the seller shall not bear any stranded costs and that the buyer shall bear them all. Under such an arrangement, what seemed like a good deal may not be such a good deal after all. For example, although a seller has an incentive to seek a low generation price, he has no incentive to consider transmission costs, stranded costs, or other expenses that may be imposed by regulatory authorities of the regions through which the power must pass in order to reach the buyer. Furthermore, if a buyer somehow breaches the contract (*e.g.*, has insufficient requirements to take the contracted amount of electricity), the seller, as the nonbreaching party, often has the contractual right to calculate its liquidated damages by *considering*, not necessarily accepting, prices quoted by published indices, quotations from "leading dealers" in energy swap contracts, or any other source.(111) Thus, contractual price provisions often expose parties to unexpected potential liability.

1. Fixed or Set Costs for Electricity

Most contractually fixed prices are for short-term contracts. This allows parties to meet periodic energy needs without facing long-term price risk. On the other hand, in 1996, Duke/Louis Dreyfus became the first power marketer to enter into a long-term agreement (10.5 years) to operate a generation facility and provide Dover, Delaware with its full power-supply requirements at a guaranteed price.(112) Such contracts are unusual because statutorily-added costs, whether through a transmission tariff or otherwise, make fixed-price guarantees difficult if not impossible.

2. Variable Prices (Including Indices)

Power does not have a common price across the country. Like natural gas, there are wide regional differences. Thus, there are numerous potential indices that traders could use to base the price of trades. For example, one index is published by the FERC.(113) The Wall Street Journal publishes price indices for power in the Western United States.(114) McGraw-Hill publishes daily price indices for power in other regions of the country.(115) The New York Mercantile Exchange ("NYMEX") has inaugurated trading in electric futures, giving a real-time method of locking in power prices.(116) These futures contracts and options are traded in several delivery locations including: California/Oregon Border ("COB"), Palo Verde, and Pennsylvania-New Jersey-Maryland ("PJM").(117) Finally, there are numerous regional reports that publish indices based upon the sales prices and volumes in the region, *e.g.*, over the prior 30 days.(118) A model may develop with informal information gathered on a daily basis (by telephoning key power traders) similar to the Platt's prices for crude oil. These indices, while possibly varying in degrees of reliability, may prove useful for buyers and sellers. Power traders

traditionally follow whichever index is most indicative of market conditions in their area and whichever index they agree upon with their customers.

3. Stranded Costs and Tariffs

Power marketers have a distinct competitive advantage over regulated utilities in providing their customers with better prices. Assume the following prices for two utilities:

TABLE 2			
	Peak Production Costs	Off-peak Production Costs	Price offered to customer to cover costs and make profit
Utility 1	5 cents per kWh	3 cents per kWh	4 cents per kWh
Utility 2	5.5 cents per kWh	2 cents per kWh	3.75 cents per kWh

Since a power marketer is not burdened with stranded costs from generation assets, it can combine Utility 1's peak prices with Utility 2's off-peak prices to deliver a rate of only 3.5 cents per kWh, beating the offer of either utility standing alone. On the other hand, power marketers are not immune from legislative tariffs imposed to recover utilities' stranded costs. Thus, when entering contracts with power marketers, price terms must be carefully drafted. For example, a contract that provides a 20% "estimated savings" but contains no contractual savings guarantee may result in only a 5% savings. A contract may also show estimated savings based upon lower payments for electricity transportation. Thus, transportation costs should be expressly included in the contract (especially because they often reflect a stranded-cost-recovery tariff) and should not be included as a pass-through item.

Contracts sometimes contain terms that specify the jurisdiction whose laws will apply to the contract. Often, such terms will provide that the laws of all applicable state and federal regulatory and governmental authorities shall apply. Unfortunately, most states have very rudimentary legislation in place to deal with wholesale or retail wheeling. Thus, contracts are subject to laws that have not yet been passed, or, worse yet, inconsistent provisions that allow different tariffs to be imposed based on the jurisdiction through which the electricity passes (*e.g.*, imposition of stranded costs based on transmission costs, CTC, or other tariffs). The parties, therefore, are forming large contracts that contain, at best, ambiguous price terms and, at worst, huge price exposure. To prevent potential losses, parties should carefully draft price provisions and clarify ambiguities that might include unexpected costs.

B. Quantity Terms

As the provision of electric power in the wholesale market becomes unbundled into separate generation, transmission, and distribution functions, the trading of electric

power begins to resemble the trading of other energy commodities: natural gas, oil, refined products, petrochemicals, etc.(119) It would seem logical to assume, therefore, that, as with other energy commodities, the sale of electric power would be treated as the sale of a "good" for legal purposes (including interpretation of the contract). This is particularly true when contracts for the purchase of electric power are unbundled into separate capacity and fixed-rate transmission services. This issue will become important in ascertaining how courts will treat contracts for the sale of unbundled electric power and, consequently, the provisions specifying the quantity sold or purchased under a particular agreement.

Article 2 of the Uniform Commercial Code ("UCC"), dealing with the Sale of Goods, provides particular remedies to buyers and sellers of "goods" for the breach of a contract within its scope.(120) Section 2-105(1) of the UCC defines "goods" as including "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities . . . and things in action."(121) This raises the legal issue of whether contracts (including quantity provisions and remedies) for the purchase and sale of electric power fall within the UCC's Article 2.

It is generally held that electric power is not a good under the UCC's Article 2 when the electric power is transmitted through a distribution system at a voltage too high for general consumer use.(122) However, courts are split as to whether Article 2 applies to the sale of electricity passed onto a consumer's lines after a transformer has dropped the voltage to a usable level.(123) For example, in New York, electricity is not considered to be a good at all within the meaning of the UCC and Article 2 does not apply directly to contracts involving the provision of electricity.(124) By contrast, the courts in Indiana and California have ruled that the furnishing by a public utility of electrical energy for household use was a sale of goods within the meaning of the UCC's Article 2.(125) Cases from other jurisdictions have reached different results based upon the specific facts of each case. For example, a Maryland court held that electricity in its "raw" state, prior to being placed into a utility's distribution system for household use, was not a good within the meaning of the UCC, but the decision noted that, in some cases, electricity may be considered a good in differing stages of distribution to end-users.(126) In any event, the future trading in the power industry, with purchase and sale agreements of electric power similar to other commodities, may result in the application of Article 2 to these contracts. This is an important issue for determining all aspects of drafting the agreement, including quantity terms.

1. Fixed Amounts

There are no standard power-trading agreements. In fact, such agreements vary broadly, largely in response to the different market conditions throughout the country.(127) Contract terms may include short or long-term provisions that specify quantities within the individual contracts. On the other hand, power traders may enter into negotiated agreements that provide flexibility and allow the parties to address changes in quantities of electric power (for delivery or capacity levels) in a separate letter agreement that is updated at particular intervals.(128) This method of

using integrated contract documents, with the initial sales and purchase master agreement setting the basic parameters of the contractual relationship, allows the parties flexibility on both quantity and price terms. Due to the fact that there is no current industry standard quantity term in power-trading contracts, a flexible approach is beneficial to buyers and sellers until market trading units are brought in line with units of futures markets (such as the NYMEX contracts for COB, Palo Verde, and PMJ).(129)

Unlike the fear of scarcity in the natural gas industry during the late 1970s and early 1980s, the dominant mood in the power-trading industry is one of abundant generating capacity in a more competitive market (which may ultimately lead to cheaper electric power on the market). This difference in philosophy is reflected in Order No. 888 by the FERC's stated purpose: "The Commission's goal is to remove impediments to competition in the wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation's electricity consumers."(130) The Order also estimates "quantitative benefits" of approximately "\$3.8 to \$5.4 billion in cost savings."(131) Under these conditions, there is presently little incentive to enter fixed quantity contracts due to the perceived abundance of electricity generating capacity. Under current public utility regulations, generating capacities are about 20% over peak demand loads in the power industry.(132) With increasingly open markets, generating capacity levels may come down, particularly if states' public utility commissions specify lower levels by regulation. Until there is a market perception that there is a shortage of generation capacity, the market incentives that caused the use of take-or-pay clauses in the natural gas industry will not occur in the electric power-trading industry.

One contract issue looms for the unwary. In the typical sales and purchase master agreement, the parties' separate agreement for price and quantity nominations may be considered a stand-alone contract. In fact, some contracts may expressly stipulate that the separate agreement on pricing and quantity shall be "controlling" in the event of a discrepancy between the two contracts. These clauses should be drafted with precision. While the later agreement on price and quantity may be controlling on these specific terms for the period set forth in the agreement, it should be pointed out in the master agreement (Sales and Purchase Agreement or Interchange Agreement) that the later contract only controls as to those specific items. Other general contract terms (such as force majeure, events of default and remedies, or arbitration provisions) should always be governed by the original and presumably more comprehensive master agreement. Drafting the contracts in this manner may avoid ambiguities that may result in later disputes between the parties.

2. Variable Amounts, Including Requirements and Output Contracts

With the advent of purchase contracts and interchange contracts that require nominations of quantity on a monthly, quarterly, or other basis, there will probably be fewer variable quantity contract terms.(133) The parties can simply make nominations for quantities of electricity over a specified term and confirm the agreement in writing.(134) However, for many end users (particularly with the growth of retail wheeling), a contract with a variable quantity provision may be desirable.

Requirements contracts may offer a method to flexibly specify the quantity of electricity purchased. Before the passage of EPACT and FERC Order No. 888, a number of contracts existed in which utilities entered into requirements contracts with customers. FERC Order No. 888 specifically addresses this issue for contracts within its jurisdiction: "The Final Rule does not generically abrogate existing requirements contracts, but will permit customers and public utilities to seek modification, or termination, of certain existing requirements contracts on a case-by-case basis." (135) However, retail wheeling agreements at the state level (*i.e.*, contracts that do not fall within the FERC's jurisdiction) may call for new requirements contracts between customers (particularly large-scale industrial and commercial users and aggregators of power purchases) and power sellers (whether utilities or power marketers). (136) These contracts should be attractive to end-users with high-volume power needs to ensure reliability of supply. (137) Given that the requirements contracts will no longer be tied solely to cost-based regulatory rates of return, legal interpretation of the contracts may turn upon state law, a novel area for the courts.

The UCC provision on requirements and output contracts states the following:

A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded. (138)

For states that consider the sale of electricity to be the sale of "goods," this provision will act as an implied contract provision governing any requirement or output contracts that are entered into between power buyers or sellers. (139) In the natural gas industry, requirements and output contracts have been held valid by the courts. (140) If a power marketer, utility, or independent power producer enters into a requirements contract with an end-user in a deregulated market, Section 2-306 imposes the following legal obligations: (a) that the quantities of power tendered remain reasonably proportionate to stated estimates in the contract or past performance levels and (b) that the seller use best efforts to supply the power and the buyer use best efforts to promote their sale. (141) This section of the UCC should be carefully examined before entering into the "new" type of requirements contracts that may emerge in a deregulated market. Given these legally imposed duties, power buyers and sellers should consider the impact of this provision and how it may affect the provision of firm power (142) under the agreement.

C. Duration (Short-Term, Intermediate, and Long-Term)

To date, no set standard for a power-trading contract's duration has been set in the industry. Power trading contracts that encompass a wide spectrum, *i.e.*, short-term contracts (minutes, hours, weeks), intermediate-range contracts (several months to one year), and long-term contracts (over one year) are appearing in the market. (143) As discussed above, the sellers of electricity, particularly in the wholesale market,

are utilizing short-term instruments that often mirror commodities contracts similar to those used in the natural gas industry.(144) Futures contracts traded on the NYMEX are quoted for monthly delivery dates (originally at COB and Palo Verde, and now at PMJ also).(145) These varying practices reflect the transition from a cost-based public utility approach to a deregulated free market approach. As retail wheeling comes into existence, large-scale users (such as industrials, cooperatives, and municipalities) may have more incentive to enter into longer-term agreements, possibly even with the quantity term governed by "requirement" provisions.

For the typical wholesale market contract (a Sales and Purchase Agreement or an Interchange Agreement), the duration is set out by the parties in the initial master agreement.(146) The terms that govern duration of nominations for quantity of electricity are, however, governed by later letter agreements.(147) Parties should consider two points when entering into these agreements. First, as discussed above, a power buyer or seller should be certain to ensure that any later agreements (typically, a confirmation letter on price and quantity terms during a specified time - frame) do not supersede the key provisions of the original, master agreement. Second, the parties should allow a reasonable termination date for the contract upon written notice (such as thirty days) to the other party. This option would allow the parties to renegotiate a contract in the event market or regulatory conditions change to the detriment of one party to the contract. If provisions are made for covering any incidental losses or liquidated damages resulting from early termination, these provisions will allow power buyers and sellers to avoid the possible difficulties of long-term contracting in a rapidly changing environment.

D. Force Majeure Provisions and Firm Supply

One of the most important issues in power- trading contracts is how to ensure that the contract provides for firm power but also includes a "force majeure" clause to account for factors affecting the delivery of power (or changing conditions) beyond the parties' control.(148) A key question that arises is: How "firm" is firm power in an agreement for the sale and purchase of electricity?(149) Another key question is: How do force majeure clauses govern power-trading contracts if an unforeseen event renders performance impossible or impracticable?

At a minimum, the contract in place in the industry should call for each party to use their best efforts when supplying power under a contract. Despite this fact, interruptions in the generation or transmission of power can affect the fulfillment of obligations under the contract. Typically, these issues are dealt with in two ways: clauses dealing with "default" under the contract with remedies for a breach (discussed below) and force majeure provisions. The scope of this latter provision, the force majeure clause, can have a drastic impact on the contract.

With respect to firm power, many power marketers have associated themselves with trading pools that are implementing standardized contract terms into the power trades made between members.(150) One example is the Western Systems Power Pool Agreement entered into by each member of the Western Systems Power Pool ("WSPP") to promote efficiency in the sale and transmission of electric power in the Western region of the United States.(151) In particular, Service Schedule C to

the contract allows for the provision of firm system capacity/energy sales in trades between members of the WSPP. Section C-3 establishes the following guidelines:

A Party may schedule Firm System Capacity/Energy Sale or Exchange Service from another Party by mutual agreement; provided, however, that each Party shall be the sole judge as to the extent to and the conditions under which it is willing to provide or receive such service hereunder consistent with statutory requirements and contractual commitments. Once an agreement is reached, then the obligation for Firm System Capacity/Energy Sale or Exchange Service becomes a firm commitment, for both Parties, for the agreed services and terms.(152)

While this provision is still broad in scope, it represents an attempt to introduce uniformity into power-trading contracts. It is important that the concept of "firm" power (whether energy or capacity) be spelled out in every contract to avoid later disputes.

With respect to force majeure clauses, standard provisions should be placed in power-trading contracts covering events outside of the control of the parties. A force majeure clause gives a party to a contract an excuse for nonperformance in the event it becomes impossible to perform under the contract terms.(153) These situations may develop in power-trading contracts from physical impossibility (such as the inability to obtain or transmit electric power under the contract) or commercial impracticability (changes in the regulatory or market environment). To anticipate these events, force majeure clauses should be an integral part of any power-trading contract. Force majeure clauses should contemplate future physical or commercial conditions in at least several key areas: acts of God or natural disasters, mechanical difficulties in the generation or transmission of electric power, catastrophes of human creation (war, strikes, etc.), and, more importantly, changed market or regulatory conditions. The detail with which events are listed in these clauses can vary considerably. In the oil and gas industry, force majeure clauses vary in length from fifty words to five or six hundred words.(154)

With the changing regulatory landscape in the regulatory arena, the parties to a power contract should include a force majeure definition that expressly provides for unanticipated events by federal, state, and local governmental or regulatory authorities. Contemplated changes by the FERC and state public utility commissions will lead to rapid changes in the power industry. Contracts drafted in both the wholesale and retail market should anticipate these changes. An example from the natural gas industry demonstrates this point. In *Atlantic Richfield Co. v. ANR Pipeline Co.*,(155) a Texas appellate court affirmed a jury verdict in favor of the natural gas pipeline relieving it of its obligation to perform under a take-or-pay contract due to events of "force majeure" from a governmental order. The court held that FERC Order No. 380, which relieved pipeline customers of the obligation to pay for gas not taken under the contract with the producer applied, as a matter of law, when a force majeure clause was written to account for "laws, orders, rules, regulations, acts or restraints of any government or governmental body or authority, civil or military."(156) In its opinion, the court reasoned that "the parties were at

liberty to define force majeure in whatever manner they desired."(157)

Similar situations could potentially develop in the powertrading industry. With the anticipated regulatory changes on the federal level from the FERC (or even Congressional action) and the state level, existing wholesale market contracts may be subject to totally changed conditions. In order to prevent difficulties from litigation due to an adverse and material government ruling, this type of clause (including acts of regulatory or governmental bodies) should be included in the definition of force majeure in a power-trading contract.

In addition, market changes should be contemplated in a force majeure clause. The parties may desire to include or expressly exclude price variations to avoid a claim that an event of "price majeure" has rendered a power-trading contract commercially impracticable. These swings in prices may render it impractical (or unprofitable) for a seller of electric power to provide supplies under the contract in the event the market price rises unexpectedly, and the same problem could confront a buyer in the event the market price falls dramatically. To remedy this situation, the force majeure provision should expressly exclude market or price adjustments as events excusing nonperformance. This may include price adjustments for future tariffs imposed for transmission or imposition of stranded costs. Early contemplation of these issues in the contract may relieve events of default in the dealings between the parties to a power contract.

Finally, two other elements should be included in force majeure contracts. First, a party should not be relieved for events that are within its control or due to its own negligence. Instead, the clauses should expressly provide for an affirmative duty upon each party to use due diligence or best efforts to remedy any unanticipated events. Second, a notification provision should be included. In the event of an unanticipated event (such as a power transmission interruption), notice to the buyer or seller should be required under the contract. This will allow parties to cover potential losses with advance warning of the event of force majeure.

E. Events of Default and Remedies

In a power-trading contract, events of default should be contemplated with regard to failure to deliver electricity, failure to take electricity, or failure to pay. These areas are of the most critical concern in an agreement for the purchase and sale of power. If the contract is governed by the UCC, then specific remedies may be provided as "gap-fillers" in the contract.(158) Nonetheless, specific events of default and remedies, including liquidated damages for a party covering losses incurred by a breach of the contract, should be expressly provided for in a power-trading contract.

The agreement should identify all events of default. It should identify whether contractual remedies will apply for "minor events of default (such as a short-term, limited interruption in supply) or whether termination is appropriate for a "major" event of default (such as repudiation of the contract). For a failure to deliver power by the seller, the buyer should be entitled to cover his losses. Conversely, a failure to take delivery of power by the buyer should entitle the seller to cover his losses. This measure of "liquidated" damages as a direct result of the breach of the contract

should include a reasonable, market-based approach. These direct damages can be measured by the fair market cost of replacement or "covering" by buying or selling power to remedy the breach.

The fair market value of damages is measured differently for the buyer and the seller under this standard. For the buyer, it is calculated by subtracting the costs of acquiring power in the market from the contract price. In the case of the seller, it is calculated by subtracting the contract sales price from either the price at which the power not taken is actually sold or the cost at which the power for the contract was acquired or generated.(159) Many industry contracts typically contain such provisions for current wholesale transactions. The parties may also include as "costs" for calculation of liquidated damages the transactional costs, or, in the event of litigation, the attorney's fees involved in remedying the breach.

With regard to failure to pay, the parties can fashion remedies found in commercial contracts for billing and payment that can solve these issues. One unique issue may arise: interest charge on late payments. A party to a power-trading contract should ensure that the interest rate for late payments fixed in the contract does not exceed the lawful amount allowed to be charged as interest in a particular jurisdiction. To do otherwise may be to run afoul of usury statutes imposed by the states.(160) This concern can be addressed by including a savings clause which provides that, "in the alternative, the interest shall not exceed the maximum amount allowed by law" in the applicable jurisdiction.

There are other particular areas of damages that a prudent power trader may wish to address. One such area is that of consequential damages which may potentially be suffered by an end-user of electric power. In the event a seller of electricity is unable to perform the contract and provide power to the buyer, the measure of damages may be contractually limited to include only direct losses from the costs of obtaining alternate power sources. Consequential damages from lost profits or business interruptions must be dealt with in the contract. For a power marketer selling power, the incentive is to exclude such damages from the contract. A buyer of power may wish to retain the option of recovering such damages. Another area of possible danger from a tort cause of action is punitive damages. This area of damages may be excluded from the contract entirely by an express provision. These issues must be addressed to avoid potential "megalosses" related to power-trading contracts. Not only can damage claims arise from breach of contract, but a power trader must also be wary of potential tort claims (such as tortious interference with contract) which may arise in various jurisdictions. Another means of limiting exposure from these dangers rests in the selection of the forum and governing law in the contract.

F. Choices of Forum and Law

If litigation results regarding a power contract, one of the first and most important choices confronting the non-breaching party is where to seek redress. This includes both the choice of the appropriate forum and the law governing the dispute. As in many other areas involving commercial disputes, there are numerous choices available. First, the parties to a power-trading contract should consider arbitration

as an alternative to litigation. Second, if arbitration is not the chosen alternative, a specific forum may be selected for resolution of court disputes. Finally, the parties should specify the law governing the contract. These basic elements should be inherent in any major commercial transaction. The rapid pace of trading in electric power, however, can often lead to an oversight in adding these provisions to a contract.

1. Arbitration Provisions

For contracts involving the movement of goods in interstate commerce, the terms of the Federal Arbitration Act will govern enforcement of an arbitration clause in the contract.(161) The provisions of the Federal Arbitration Act apply to all contracts evidencing transactions in interstate commerce.(162) The United States Supreme Court has uniformly applied the Act as evidencing a "congressional declaration of a liberal federal policy favoring arbitration agreements."(163) Given that most wholesale power trades will inevitably involve interstate commerce, the provision of the Federal Arbitration Act should allow for enforcement of arbitration provisions. In addition, individual states often have enacted Arbitration Acts modeled after the federal act.

The arbitration clause allows for resolution by a panel of arbitrators, either picked by the parties or an outside entity, to resolve the dispute rather than going through a protracted expensive court proceeding. These provisions offer the advantage of allowing the parties to bring experienced industry personnel, former members of the judiciary, or distinguished members of the bar to resolve a dispute. A potential downside to arbitration is the possible undue speed of the procedure and the lack of an appellate remedy absent a showing of fraud, duress, or undue influence of the arbitrator.

There are a number of available alternatives when drafting arbitration clauses. The American Arbitration Association offers information on drafting arbitration clauses for commercial disputes that may provide a reference.(164) In addition, the parties may chose to conduct the arbitration with arbitrators picked by the parties (jointly), with a panel (perhaps one selected by each party and a neutral arbitrator then elected), or by a governing body in the electric power industry. Many alternatives are available to streamline future contractual disputes.

One difficulty may arise in the structure of current powertrading contracts. If a master agreement is executed with later agreements to be executed between the parties, the master agreement should be carefully drafted to ensure that the arbitration provision applies to the future contracts. In at least one federal case(165) involving take-or-pay disputes, the existence of gas purchase agreements with arbitration clauses side-by-side with other documents (without arbitration clauses) ultimately resulted in chaos. Parallel litigation and arbitration proceedings took place, but the federal courts ultimately ruled that the arbitration provisions did not govern the dispute.(166) This type of difficulty can be avoided by careful drafting with regard to any superseding agreements. The fact that the arbitration provision governs any and all agreements between the parties, including any other letters or later documents evidencing nominations of price, quantity, and duration of electric

power purchases and sales should be clearly stated in the contract.

2. Choice of Forum

In the event that an arbitration provision is not included in the contract, the parties may consider a choice of forum provision. Such a provision specifically designates the place in which a lawsuit must be filed.⁽¹⁶⁷⁾ Again, this will add a degree of certainty to the resolution of the dispute and may impact the applicable law in some states.

3. Choice of Law

A provision should also be included in every power-trading agreement regarding choice of the governing law (regardless of whether the contract is to be enforced by arbitration or litigation). For any contract that is outside of the FERC's jurisdiction, issues may arise involving interpretation of several states' contract laws (including the provisions of the states' versions of the UCC if held to apply to the sale of electricity). Failure to include such a provision will raise two problems: first, uncertainty as to the governing principles of law for the contract and, second, the forum in which a dispute will be litigated if necessary. Often, a suit may be filed (or transferred by motion of a party) to the jurisdiction whose law governs the agreement if other factors make the selected state a proper forum.

To eliminate these uncertainties, every power-trading contract clause should contain a simple provision: a choice of law clause. The form does not necessarily matter,⁽¹⁶⁸⁾ but the issue is important. Designation of the law of a particular state can impact such issues as whether the UCC governs the contract remedies and damages recoverable in the event of a breach; recovery of punitive damages and applicable limitations on such remedy; recovery of costs; and, importantly, attorney's fees. This must be determined for each contract depending upon the nature and physical location of the transaction.

V. CONCLUSION

This article has attempted to address the issues that will face power buyers and sellers when dealing with a newly-deregulated and competitive market. The wholesale market for power trading is already operating. The retail markets will appear, on a state-by-state basis, over the course of a number of years. For both of these types of markets, however, the central theme is the same: **POWER BUYERS AND SELLERS SHOULD WORK TO DEVELOP FIRM POWER PURCHASE AND SALE AGREEMENTS THAT ENSURE RELIABLE SUPPLIES OF POWER AT MARKET- BASED PRICES.** It may take time for each individual power buyer or seller to devise its own contract to attempt to "standardize" contract terms in the industry. Nevertheless, the experience in the natural gas industry and the emerging contracts in the wholesale market are both useful starting points for finding meaningful solutions.

In the absence of a national standard, whether imposed by governmental regulations or the cooperative efforts of members of the electric power industry, these contract

issues may vary from region to region. Undoubtedly, group efforts to standardize contract terms, such as the Western Systems Power Pool Contract, will emerge in the future. These standardized contracts will assist buyers and sellers in focusing on the negotiation of agreements. The ultimate issue, however, will be whether future contracts shaped in the power industry will provide flexible and workable alternatives for resolving disputes. The alternative is the testing of these contracts in the crucible of litigation.

Avoiding "Megalosses" in Drafting the Provisions of Electric Power Trading Contracts

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I. OVERVIEW OF THE ISSUES

This article addresses potential concerns for buyers and sellers in the electric power industry in the making and the performance of contracts involving the purchase and sale of electricity (both energy and capacity). Contracts are generally executed for two basic purposes: first, to make a profit, and second, to ensure certainty of the supply of goods and services. Unfortunately, changing market and regulatory conditions can alter the assumptions under which the parties entered into the contract. The result is often a situation in which one party decides that it is better to breach the contract than to perform. The nonbreaching party may be stranded with losses or must resort to litigation to enforce its contractual rights.

The electric power industry is changing at an ever-quicken pace: enormous market opportunities are being created by the Federal Energy Regulatory Commission's ("FERC") recent unbundling of transmission services, its allowances of open access in the wholesale market and the emergence of retail wheeling in a number of states.(1) The industry is quickly evolving. Unfortunately, rapid deregulation at both the wholesale and retail level as well as the frantic rush to gain market share may leave a trail of agreements in which the key terms are drafted with imprecision if the agreement is written at all.(2)

A key issue for parties drafting contracts for the purchase or sale of electric power will be the transition to a deregulated market environment. The growing wholesale and retail markets make these contract issues increasingly more important. Drafters can avoid many significant problems by learning from the lessons of the past deregulation of the

natural gas industry. In Order No. 888, the FERC recognized that the agency "learned from ... [its] experience in the natural gas area the importance of addressing competitive transition issues early and with as much certainty to market participants as possible."⁽³⁾ Drawing on the litigation experiences of the natural gas industry from the past decade, those engaged in the buying and selling of electric power can avoid some of the potential pitfalls and resulting losses (such as the "megalosses" in the billions of dollars from natural gas take-or-pay clauses⁽⁴⁾) with careful planning and policy decision-making.⁽⁵⁾

To examine these potential areas of concern in the electric power industry, this paper considers the following basic contractual terms: (a) price, (b) quantity, (c) duration, (d) force majeure, (e) defaults and remedies, and (f) choices of forum for dispute resolution and governing law. This list is not exhaustive. As the industry faces reduced federal and state deregulation, competition in the marketplace will dictate creative solutions to contract issues. Some fundamental provisions, however, should be considered in all contracts-whether short-term, intermediate or long-term-in order to avoid the possibility of future losses.

II. THE LESSONS OF HISTORY: THE NATURAL GAS CONTRACT EXPERIENCE

As the electric power industry rapidly changes through deregulation and increased market competition, the question arises: what lessons can be learned from the disastrous experience of natural gas litigation from the past several decades?⁽⁶⁾ For those who lived through it, the answer seems simple enough: protect your position in the contracts you make, whether as a buyer, seller, or broker of electric power.⁽⁷⁾ In implementing this philosophy however, power traders may feel a false sense of security. First, a power trader can examine the lessons of the natural gas experience and presumably eliminate any obvious contract deficiencies from the start. Second, unlike the natural gas industry during the 1970s and 1980s, deregulation is taking effect before power-trading contracts are going to be executed (at least at the retail level). Power traders can rest assured of a competitive wholesale marketplace via implementation of FERC Order No. 888, that will be enhanced by pending deregulation of the retail market by the states. This should substantially mitigate the difficulties natural gas pipelines experienced in the 1980s from take-or-pay clauses. Finally, electricity is simply different from natural gas. Once generated, it cannot be economically stored and will not wait for a delivery date under a contract. By this fact alone, it would seem that the ominous "take-or-pay" disaster of the 1980s can be avoided.

There are, however, several reasons to expect that at least some of the pitfalls which led to massive natural gas litigation may also await the power-trading industry. To begin with, although deregulation is increasing market opportunity, it is also creating contractual uncertainty. For example, although FERC Order No. 888 provides for open access by unbundling transmission services, it creates new issues such as multiple methods (under state or federal law) by which stranded generation costs may be recovered through transmission rates.⁽⁸⁾ In addition, the FERC's Notice of Proposed Rulemaking ("NOPR") for the Capacity Reservation Tariff ("CRT")⁽⁹⁾ released the same time as Order No. 888, could potentially result in a total change of the power-trading system currently in place. Instead of "load-based" network service, transmission of power would be accomplished through firm rights to capacity on electric transmission grids. In

short, the power- trading industry, like the natural gas industry, will be subjected to constantly changing conditions based on regulatory changes at the federal and state levels.

What lessons can be learned in a changing environment in the power-trading industry from the natural gas experience? The lesson is not to deny the potential for a recurrence of that phenomenon when drafting contract provisions. Buyers and sellers of electric power must carefully consider how each contract term may be affected by, or may account for, altered market or regulatory conditions. This is, of course, particularly important with respect to the key terms such as price, quantity, and duration. It would be foolish, however, to think that any drafting could perfectly anticipate the vicissitudes of the market, the legislature, and the regulator. Therefore, guarding the "back-door" in the key contract provisions is critical. Specific remedies must be crafted for the inevitable time when one party to a power-trading contract finds itself overwhelmed by opportunity or exigency, and decides simply to breach the agreement and take (or litigate) the consequences.

A. Losses Experienced in the Natural Gas Industry

During the 1970s and early 1980s, pipeline companies incurred massive take-or-pay risk.(10) Take-or-pay provisions had been an integral portion of wellhead purchase contracts for years as the FERC, then required to regulate wellhead prices, attempted to encourage stability. To encourage exploration and production, the FERC changed the rates and then legislated themselves out of the wellhead pricing business altogether. The take-or-pay provisions required pipeline companies to pay for specified gas volumes (typically, a percentage of well deliverability) even if they could not sell the gas. Although these provisions first pertained only to a duration of one year or less, the duration terms were subsequently expanded to longer periods. The take-or-pay liabilities then began to materialize and grew to extraordinary levels. This growth was fueled by the fact that many pipeline companies were facing a situation where their sales and prices were rapidly declining. This forced these pipeline companies to realize that they would be unable to sell (or resell) the minimum gas volumes for which they were bound to purchase by long-term contracts.(11)

The severe gas shortages during the 1970s led to the enactment of the Natural Gas Policy Act of 1978 (" NGPA") which, among other things, began deregulation of prices for most new gas and allowed for an increase in ceiling prices over those previously established by the FERC.(12) To avoid future shortages, pipelines quickly entered into *long-term* take-or-pay contracts at the high prices made possible by the NGPA. Those high prices stimulated producers to greatly increase exploration and drilling.(13) Unfortunately, by 1982, demand began falling and by 1983, demand for natural gas was drastically lower than in 1979.(14) As a result, supply far exceeded demand throughout the remainder of the 1980s. By 1989, the FERC estimated in Order 500-H that pipeline companies had about \$44 billion in take-or-pay liability.(15)

The FERC issued its Order No. 500 in 1987 in order to allow pipelines to allocate their take- or-pay settlement costs among all of their customers.(16) As a result, many pipelines renegotiated their contracts as soon as possible by agreeing to pay the producers some fraction of their potential claims. Unfortunately, these negotiations took

place in the context of FERC Order 380, which prohibited the passing of settlement costs on to pipeline customers.(17) Five years later, the FERC issued Order No. 636 to unbundle transportation services and to stimulate competition.(18) This required the pipelines to provide transportation services on an equal basis for all supplies regardless of where the gas supplies were purchased.(19) This process may be contrasted with the FERC's Order No. 888 which at the same time requires open access to electric transmission facilities and allows electric utilities to allocate their stranded costs (incurred due to loss of customer load from competition) among wholesale customers.

B. A Review of Inherent Problems in Natural Gas Contracts

It would be an oversimplification to attribute \$44 billion of contractual liability to the mere fact that take-or-pay provisions were in the contracts.(20) We submit instead that the difficulties of the 1970s and 1980s were created by problematic drafting of the contracts and a lack of flexibility in the agreements to deal with instability (such as market change or deregulation). As explained by Justice Bowman of the United States Court of Appeals for the Eighth Circuit:

The damages issues raised by the parties are complex. They arise against a backdrop of government regulation, and grow out of ambiguous and otherwise unclear provisions in contracts between the parties for the purchase and sale of natural gas at prices that ceased to reflect market conditions once Congress' partial deregulation of the natural gas industry in the 1980s had turned a shortage of natural gas into an abundant supply.(21)

Take-or-pay provisions often required pipeline companies to purchase gas at high prices that were tied to the escalating price provisions provided for by the NGPA.(22) Unfortunately, under the provisions of FERC Order No. 380, the pipelines had no ability to pass on to their customers the costs for gas that was paid for but not taken.(23) The FERC tried, partially and belatedly, to patch-up the take-or-pay disaster by Order No. 636 that allowed natural gas pipelines to recover some of their losses through "transition costs."(24) This was too little, too late for many contracting parties. In addition to the obvious price and quantity difficulties of take-or-pay provisions, the contracts also contained duration terms that stretched the performance dates up to many years.

When confronted with long-term take-or-pay problems, a natural gas pipeline had four alternatives:

- (1) buy-down the high contract prices per Mcf of gas and continue to perform under this lower price term;
- (2) buy-out the contract completely and fulfill its obligations to customers through purchases at the lower market prices for gas;
- (3) breach the contract through anticipatory repudiation and resolve the matter through settlement or litigation; or
- (4) do nothing.

Some natural gas pipelines chose the last alternative. They reasoned that as long as they were not tendered any high-priced gas under the contracts (often from small, independent producers who did not have high delivery capacities), there was simply no take-or-pay problem. Thus, short-term reasoning failed when, years later, these contracts were assigned by small, independent producers who were nonetheless astutely aware of the contractual rights, to big producers that had the capacity to deliver huge volumes of natural gas to the pipelines. The contracts' duration terms often stretched their performance into the mid-1990s. Since many of these agreements also contained open-ended quantity provisions, the amount of gas tendered for delivery was astounding. The result was a new round of litigation on several issues: whether the contracts were subject to limitations on good-faith delivery of product and whether such contracts were freely assignable.

Recent court decisions have firmly brought home the lesson that a contract of lasting duration with an open-ended delivery provision may lead to disastrous results. For example, in 1996 the Texas Supreme Court in *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*(25) considered a claim under such a contract and found that the take-or-pay provision was still viable and not subject to Section 2.306 of the Uniform Commercial Code that puts a limit on output contracts. These scenarios obviously can lead companies to lose significant, if not overwhelming amounts, of money through litigation and settlements. Whether the electric industry will remember these lessons and profit from them is yet to be seen.

III. THE POTENTIAL FOR "MEGALOSSES" IN THE ELECTRIC POWER INDUSTRY

History need not be repeated if the lessons learned from the natural gas experience are proactively applied to meet the challenges that will confront buyers and sellers in the emerging electric power-trading industry.

A. Structure of The Current Marketplace

The electricity sales industry is one of the largest in the country, yielding annual revenues of approximately \$200 billion.(26) To put the industry in perspective, it is roughly 3.2% of the gross domestic product or triple the size of the local and long-distance telecommunications industry.(27)

Power marketers are a new entrant into this large, growing industry. Before 1992, the sale of electricity was heavily regulated. Since 1978, competition in the electric generation market had grown dramatically under the protection of the Public Utility Regulatory Process Act of 1978 ("PURPA"), which protected certain "Qualifying Facilities" from retaliation by traditional utilities, and required those utilities to buy power from the Qualifying Facilities.(28) But the passage of the Energy Policy Act of 1992 ("EPACT") dramatically relaxed some of the restrictions on the transmission services market.(29) One of EPACT's key provisions guaranteed sellers of electricity the right to access transmission lines that did not belong to them so they could deliver power to wholesale customers in distant locations. At the same time, FERC determined to allow all applicants who did not otherwise have the ability to exclude others from the electric

power market, to sell power at market-based rates, rather than FERC-set rates. As a result of these bold steps, companies of all kinds requested permission to participate in the markets. Gas marketers, utility affiliates, commodity brokers, and even investment banks went to the FERC for certification as power marketers.(30) This certificate allows the holder to buy and sell electricity at market-based prices; that is, whatever price the parties to a deal agree upon.

By mid-1994, the number of active power marketers grew from eight to fifty-two.(31) Since then, the number has doubled every year.(32) In 1996, there were 166 power marketers licensed by FERC and, by March 1997, there were 284 licensed marketers (over a 71% increase).(33)

Power marketing sales also grew rapidly. During the first half of 1996, power marketers cumulatively sold 65.5 million MWh, more than doubling the sales of 28 million MWh that they had experienced during all of 1995.(34) By the second quarter of 1997, total sales rose to 216 million Mwh.(35) Still, the recent boom in power sales only accounts for 1.4% of all wholesale electricity sales, which stood at about 1.9 billion MWh in 1995.(36) The potential wholesale market is valued at approximately \$90 billion.(37) Much of that market could open-up in the next three to five years, as long-term utility supply contracts with other utilities and non-utility generators expire.(38) But the retail market, estimated at \$110 billion, shows the most potential as states begin to adopt programs that open it up to competition.(39)

The ever-growing market is demonstrated by charting the sales of the top ten marketers in the past few years:

Company	1995 Sales (MWh)	Company	1996 Sales (Mwh)	Company	1997 through 2nd Qtr. Sales (MWh)
Enron Power	\$7,880,704	Enron Power	\$59,723,290	Enron Power	\$36,757,620
Louis Dreyfus	4,294,458	Louis Dreyfus	28,303,534	Electric Clearinghouse	16,342,031
Electric Clearinghouse	3,573,142	LG&E	17,075,223	VITOL	12,475,786
Citizens Lehman	1,937,532	Electric Clearinghouse	14,627,509	Louis Dreyfus	12,093,051
CATEX	1,175,003	VITOL	10,005,546	Southern Energy	10,621,203
R.J. Dahnke	1,127,492	KOCH Power Source	9,963,860	LG&E	9,724,519
NAEC	840,306	AQUILA	6,726,504	ILLINOVA	9,986,208
CNG	820,477	CNG	4,880,360	Engage	7,528,230

				Energy (formerly Coastal)	
NORAM	554,368	PAN ENERGY	4,239,391	Energy Power Mktg.	7,298,161

The chart reveals that at this early stage of development, some of the strongest players in the business are longtime players in the oil and gas industry. The chart also makes it clear, however, that the industry is continually evolving as new players enter the wholesale and retail markets.

B. Standard Contract Practices in The Wholesale Market

For practical purposes, competition in the electric industry has been limited to the wholesale market.(40) Recent changes have allowed the wholesale market to begin developing its own trading systems and exchanges for selling power. FERC Order Nos. 888 and 889, which opened up transmission lines to electric power wholesalers, also created an electronic information system, Open Access Same-Time Information System ("OASIS"), that is designed to provide data regarding transactions such as purchases and sales of transmission service from utilities or in secondary markets.(41) The growth of the wholesale trading market has been phenomenal since the passage of these key FERC Orders.(42)

The growth is not without concerns. Many power marketers claim that the market is dominated by a few megatraders and that the rest are not making money. In some cases, smaller power marketers are simply trying to position themselves in the market to be able to participate when competition in the electric generation market becomes more widespread through industry restructuring and divestiture. Many also complain that the current market has little liquidity.(43) Moreover, many players have complained that OASIS is deficient, if not defective. Thus, power traders without their own generation must protect their financial position by "mirror matching" sellers with buyers to take physical delivery.

Other, less-apparent problems exist in the vehicles used to make trades. Sales of electric energy are made through a variety of contractual arrangements that are analogous to commodities trading.(44) However, there are some unique characteristics to power trading. For example, electricity cannot be stored. Thus, marketers must purchase capacity, which is itself akin to an option. Unfortunately, no standard contracts exist that account for the unique requirements and characteristics of power trading. Contract terms are often left open or ambiguous by eager players in an effort to facilitate trading in an illiquid market.(45)

C. The Stranded Costs Issue: Potential Losses to be Borne By Buyers and Sellers

Stranded costs refer to a utility's investment in its generating capacity (e.g., its generating plants as well as transmission and distribution facilities) that makes it too expensive for the utility to sell power profitably in a competitive market.(46) In an effort to recoup some of these stranded costs, utilities may impose "exit fees" upon customers who choose to leave the utility and get their power from an alternate supplier.(47) Although

FERC and some states have enacted legislation that allows utilities to recover stranded costs, each has different provisions for recovery. In addition, not all commentators agree that stranded costs should be recoverable. For instance, some commentators argue that the utilities certainly anticipated deregulation, that such indemnification was not forthcoming in prior deregulated industries, and that it should not be allowed now.(48) Others argue that stranded cost recovery leads to the dichotomous supposition that the greatest protection will be afforded to those utilities that made the poorest investment decisions.(49) Still other commentators argue that stranded cost recovery should be allowed only on a case-by-case basis, if at all, and not allowed based on the presumption that all utilities will experience such costs.(50) Despite the industry dissent regarding the issue, FERC and nearly all the investor-owned utility commentators endorse the proposal of allowing stranded cost recovery.(51)

1. Stranded Cost Recovery Under FERC Order No. 888

In May 1996, the FERC issued Order No. 888: Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services and Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities. Under Order No. 888, the FERC allows utilities to recover stranded costs from their former customers so long as the costs are "legitimate, prudent, and verifiable" and consistent with a utility's "reasonable expectations" of continuing to serve its client.(52) For example, Order No. 888 allows both utilities and customers to ask the FERC to convert their existing requirements contracts into transmission capacity rights. Although former holders of requirements contracts may no longer wish to get their requirements from a high-priced utility and may wish to find a cheaper source, they will still have to use the utility's transmission lines to bring the cheaper power to their facility. Thus, the utility seeking to recover its stranded costs or the customer who feels it is being charged a disproportionate amount of stranded costs may ask the FERC to retroactively modify the old requirements contract and impose a fee that is more just.

The details of stranded costs recovery under Order No. 888 are as follows:

NEW CONTRACTS: All wholesale contracts executed after July 11, 1994, are considered new contracts.(53) Unless these contracts contain an express provision allowing the recovery of stranded costs (including a formula for calculating these costs), no recovery will be allowed.(54)

EXISTING CONTRACTS: A utility may file to recover stranded costs on "existing" wholesale contracts (those executed on or before July 11, 1994) if the parties cannot renegotiate to add such a provision in the contract.(55) The party seeking to modify the contract still has the burden to show that the contract is no longer "just and reasonable."(56) A utility may not recover stranded costs for existing wholesale contracts, however, if there is a provision explicitly prohibiting recovery.(57) Also, if a transmission or a power tariff filed by the FERC prohibits recovery of stranded costs, this too will prohibit any recovery by the utility.(58)

METHODS OF COST RECOVERY: There are three methods of recovering stranded costs in a qualified existing requirements contract:

- i. The parties may mutually renegotiate their contract, agree on a method of dealing with the stranded costs, and file the revised contract with the FERC (59);
- ii. Either or both parties may seek to amend the contract before it expires, even if the contract itself forbids the right to challenge the contract so long as no clause expressly forbids stranded cost recovery(60) ; or
- iii. The utility presently supplying power under a wholesale contract may file a request with the FERC, before the existing contract expires, to recover stranded costs through a future surcharge on its transmission rates for that customer.(61)

The FERC has exclusive jurisdiction over interstate transmission, including the transmission of electricity for retail sale (*i.e.*, retail wheeling) that local regulatory authorities have unbundled from distribution and made subject to competition.(62) Order 888 directly regulates only entities that are under the FERC's jurisdiction (*e.g.*, the nation's public utilities(63) and certain power pools(64)). The FERC, however, can indirectly regulate utilities that are not under its direct jurisdiction.(65) For example, Order No. 888 imposes reciprocity requirements that require public utilities within a state to allow the use of their transmission service and to offer the same quality of service as utilities under the FERC's direct jurisdiction.(66) This reciprocity is a condition that state-jurisdiction utilities must meet to be eligible to take advantage of open-access transmission by FERC-regulated utilities.(67) Once they meet the condition, retail customers and their suppliers within that state are eligible to apply for and obtain transmission service under Order No. 888's open-access transmission tariffs.(68)

2. State Solutions for Recovery of Stranded Costs

Different states are taking a variety of approaches to allow utilities under their jurisdiction to recover stranded costs. The following states provide a broad sampling of the methods by which states are providing for the recovery of stranded costs.

CALIFORNIA: As of January 1, 1998, California will impose a "non-bypassable" exit fee called the Competition Transition Charge ("CTC") on utility customers departing because of cheaper rates elsewhere.(69) The CTC is designed to recover the approximately \$22 billion incurred by the state's investor owned utilities.(70) However, the January implementation date was initially delayed until March 31, 1998 because of computer problems with the new software that links the state's electricity transmission operating system and distribution network.(71) The CTC will only be imposed over the transition period during which the state will adopt retail wheeling.(72) The new legislation has also guaranteed a 10% rate reduction for residential and small commercial customers beginning on January 1, 1998,(73) and a cumulative rate reduction of at least 20%(74) beginning April 1, 2002. Finally, customers can exempt themselves from the CTC by building their own cogeneration plant.(75)

The California Public Utility Commission recently approved \$7.3 billion in bonds to finance a rate reduction for residential and small business customers beginning January

1998.(76) Those customers will repay the bonds during the time period from the year 2002 until the year 2008 as their portion of "competition transition charge" that the utility companies will charge all its customers during the time period from the year 1998 until the year 2002 in an effort to recoup stranded costs.(77)

RHODE ISLAND: On August 7, 1996, Rhode Island passed its Utility Restructuring Act which will permit retail wheeling by July 1, 1998.(78) Rhode Island will permit the recovery of stranded costs through a "transition charge" that will be assessed over a twelve-and-one-half year period (from July 1, 1997 through December 31, 2009).(79) The charge will be 2.8 cents/kWh through December 31, 2000 and will be adjusted by the Rhode Island Public Utilities Commission thereafter.(80)

The Act also requires utilities to divest generating facilities. Each Rhode Island public utility must file a plan for transferring ownership of generation, transmission, and distribution facilities into separate affiliates by January 1, 1997.(81) The utilities, however, will continue to provide a "standard offer" at current prices adjusted for inflation through 2009 to protect those customers who do not wish to switch companies.(82)

PENNSYLVANIA: On December 3, 1996, Pennsylvania enacted legislation deregulating the electric industry and phasing in retail competition.(83) The phase-in begins in January 1999 and culminates in full customer choice by 2001.(84) The Pennsylvania law allows for the recovery of stranded costs via a competitive transition charge over a period of up to nine years.(85) The law also allows utilities to issue transition bonds to help them recover stranded costs.(86) The law requires "rate caps" on utility charges to customers during the transition period.(87)

Under the Pennsylvania plan, utilities will not be guaranteed 100% recovery of their stranded costs. The Pennsylvania public utility commission will determine what amount of a utility's stranded costs may be recoverable because they were "[p]rudently incurred, . . . [and] generally recoverable in a regulated industry but potentially nonrecoverable in [a] competitive generation marketplace."(88) Thus, the utility commission will attempt to distinguish between stranded costs that resulted from poor management and those that resulted from valid regulatory requirements.

MASSACHUSETTS: Like Rhode Island, Massachusetts has proposed a plan that requires utilities to recover stranded costs by divesting themselves of generation assets at market value by the year 2001.(89) The plan would only allow utilities to recover stranded costs after they sell off their portfolio of generation assets to the highest bidder.(90) The plan has no stranded cost recovery provisions for utilities that do not sell their generation assets.(91) This recovery plan does not rely on forecasts and has the distinct advantage of creating firm stranded cost numbers.

TEXAS: The Texas legislature introduced the state's most recent power restructuring plan during its 1997 legislative session. The bill provides that stranded cost recovery should be calculated as the difference between the value of all the utility's power generation assets that have a book value equal to or greater than market value; and the value of those assets that have a book value less than market value.(92) The bill also required the utility seeking to recover stranded investments to "aggressively mitigate any

uneconomic investments."(93) This potentially would have allowed Texas utilities to recover billions of dollars of stranded costs especially those associated with HL&P's South Texas and Texas Utilities' Comanche nuclear plants.(94) The proposed bill required that the utility's shareholders and customers share stranded cost recovery equitably but disallowed the use of exit fees unless the departing customer agreed to pay such a fee.(95) Unfortunately, the deregulation bill collapsed in the 1997 Texas Legislature, so the next opportunity to consider power deregulation will have to be examined when the Legislature reconvenes in 1999.(96)

VERMONT: The Vermont plan would allow utilities to recover stranded costs through state issued bonds backed by transmission "wire charges" that will apply to all customers that use transmission lines (as opposed to strictly local distribution lines) to receive their electricity.(97)

3. Practical Implications of FERC Order No. 888 and State Regulations

State solutions may conflict with FERC Order No. 888. Thus, power purchase agreements should clearly include detailed treatment of future stranded costs to avoid unexpected increases in the cost of power from regulated allocation of stranded costs. Parties to the contracts must first consider factors such as the outside regulatory forces that may affect their pricing structure for power. For example, a utility subject to the FERC's jurisdiction should evaluate its individual contracts to determine whether it is a "new contract" (*i.e.*, one that is dated after July 11, 1994) or an "existing contract" (*i.e.*, one dated on or before July 11, 1994). It should then evaluate methods of cost recovery (or cost avoidance) available using methods such as (1) renegotiation of the contract between the parties, (2) amending the contract, or (3) requesting a surcharge on transmission rates. Similarly, parties that are subject to the jurisdiction of a particular state's regulators should evaluate the state-specific requirements and tariffs. For example, Oklahoma and Oregon have begun investigations into restructuring their electrical industries.(98) The Texas legislature has also passed a bill that substantially deregulates the Texas wholesale market but does not address retail wheeling.(99) In light of the expanding wholesale and retail markets, traders are well-advised to consider the jurisdictions in which they trade, re-evaluate their existing contracts, and take affirmative steps to efficiently structure new contracts to reap the benefits (or avoid the pitfalls) of deregulation.(100)

D. Risks Inherent in Both Wholesale and Retail Market Contracts

There is a tremendous amount of uncertainty inherent in power trading. For example, there are seemingly countless buyers and sellers(101) as well as a large variety of potential transactions. In addition, power traded in one state can ultimately wind up being transmitted to an end-user in another state. As each state imposes different regulatory requirements for the implementation of retail wheeling, contracts must reflect the unique issues raised in every state. Thus, arising from the increased competition and market opportunity, there is also a high potential for variation among different contracts as well as key provisions in a single agreement. The best means to avoid losses is to consider the long-term impact of the fundamental terms in a contract upon the seller or buyer.

The main areas of risk inherent in power-trading contracts will be similar to those which caused difficulties in the natural gas industry: price, quantity, duration, force majeure, defaults and remedies, choices of forum, and choices of law. For example, in determining price, parties must consider multiple issues such as:

- i. how will the risk and cost of stranded costs be borne between buyers and sellers in power-trading contracts;
- ii. what constitutes a stranded cost-,
- iii. how do changing regulatory requirements impact the price terms of an existing contract; and
- iv. what constitutes a reasonable price for electricity -- is it a price quoted by the New York Mercantile Exchange ("NYMEX") futures contracts price, informal price quotes from market leaders in electric power trading, or other contract prices implemented by buyers and sellers?

The impact of such considerations will be wide-spread to players in the industry. As large-scale industrial users attempt to lower their production costs by renegotiating their cost of electricity, they will necessarily reshape their contracts for power and face new issues relating to these contracts. Although power traders in the wholesale market are gaining experience on a daily basis, they will also be faced with new contract issues (along with competitive markets) with the opening of industrial and retail markets.

E. Power Trading Contracts: Avoiding The "Efficient" Breach

For a buyer or seller of electricity, the main goal of a contract is to make a profit and establish certainty of supply. From a legal perspective, however, a contract is viewed in a different way. Ironically, the law defines contracts more in terms of their breach than in terms of their execution by the parties.(102)

In the emerging power-trading industry, there will be two competing interests in every contract: a desire to avoid losses from risk and a desire to incorporate flexibility into the terms of the contract. Unfortunately, these two calculations are different depending upon whether the party is a buyer or a seller. A buyer (such as a large-scale industrial user or municipality) may consider certainty and risk avoidance as more important than flexibility. While such a buyer may wish to lower its energy costs, it also wants to ensure a stable, steady supply of electricity in order to avoid losses from power outages. A seller, on the other hand, has an incentive to maximize the price received for the power, possibly through flexible pricing provisions that ensure that its cost in obtaining power from a third-party supplier will not be greater than the contract price it receives from the buyer.(103)

In drafting future power-trading contracts, the question thus becomes how to balance the competing interests of buyers and sellers. For example, short-term contracts at variable prices introduce an element of risk that many end-users may not be willing to bear. On the other hand, long-term contracts at set prices will reduce risks of supply interruption

but will increase the risk of losses from market or regulatory changes. Long-term contracts also increase the risk of an "efficient breach" if market conditions make performance under the contract uneconomical.(104) Such practices were illustrated in the natural gas industry when a pipeline faced with a take-or-pay contract for a fixed quantity at an above market price had little option other than to either buy-out (or buy-down) the contract or simply breach it.(105) Thus, if a natural gas purchaser felt that it would be less costly to repudiate the contract with the producer as seller and refused to perform, it was "efficient" to breach the contract. The buyer then purchased gas on the market at lower prices and hoped that the costs of litigation were less than the cost to perform under the agreements. With rare exceptions,(106) the pipelines were ultimately required to pay liquidated damages under the contracts.

Currently, power contracts are usually short-term or intermediate-term and reference individual "pricing agreements" that require the buyer and seller to nominate price and quantity on a continually revised basis.(107) In the current market, there appears to be little incentive to negotiate long-term (or even intermediate-term) contracts.(108) Power traders must focus on the daily swings in the market rather than on the securing of long-term supplies of electric power. These power traders do, however, have an incentive to gain long-term market share. Also, as retail wheeling becomes available, end-users may have more incentive to negotiate longer-term contracts in order to eliminate supply uncertainties or market-wide price swings.(109) These alternative, speculative scenarios mean only one thing: no one can say with certainty what the power market will look like in the near or longer term future. All of these possibilities should be a reminder to attempt to eliminate market and regulatory uncertainty from future contracts.

IV. ELECTRIC POWER CONTRACT TERMS AND CONDITIONS: HOW TO AVOID "MEGALOSSES"

This section reviews the fundamental terms of power-trading agreements in light of the litigation that resulted from the past problems that plagued the natural gas industry. While the issues regarding power-trading contracts will remain unclear until the wholesale and retail markets become truly competitive, consideration of several of these issues may prevent future problems for the buyers and sellers of electric power.

A. Price Provisions

Although deregulated sellers of electricity often promise potential cost savings in comparison to traditional utilities, powertrading contracts often allocate transmission costs and other miscellaneous expenses to a single party, usually the buyer.(110) In fact, such contracts often expressly state that the seller shall not bear any stranded costs and that the buyer shall bear them all. Under such an arrangement, what seemed like a good deal may not be such a good deal after all. For example, although a seller has an incentive to seek a low generation price, he has no incentive to consider transmission costs, stranded costs, or other expenses that may be imposed by regulatory authorities of the regions through which the power must pass in order to reach the buyer. Furthermore, if a buyer somehow breaches the contract (*e.g.*, has insufficient requirements to take the contracted amount of electricity), the seller, as the nonbreaching party, often has the contractual right to calculate its liquidated damages by *considering*, not necessarily

accepting, prices quoted by published indices, quotations from "leading dealers" in energy swap contracts, or any other source.(111) Thus, contractual price provisions often expose parties to unexpected potential liability.

1. Fixed or Set Costs for Electricity

Most contractually fixed prices are for short-term contracts. This allows parties to meet periodic energy needs without facing long-term price risk. On the other hand, in 1996, Duke/Louis Dreyfus became the first power marketer to enter into a long-term agreement (10.5 years) to operate a generation facility and provide Dover, Delaware with its full power-supply requirements at a guaranteed price.(112) Such contracts are unusual because statutorily-added costs, whether through a transmission tariff or otherwise, make fixed-price guarantees difficult if not impossible.

2. Variable Prices (Including Indices)

Power does not have a common price across the country. Like natural gas, there are wide regional differences. Thus, there are numerous potential indices that traders could use to base the price of trades. For example, one index is published by the FERC.(113) The Wall Street Journal publishes price indices for power in the Western United States.(114) McGraw-Hill publishes daily price indices for power in other regions of the country.(115) The New York Mercantile Exchange ("NYMEX") has inaugurated trading in electric futures, giving a real-time method of locking in power prices.(116) These futures contracts and options are traded in several delivery locations including: California/Oregon Border ("COB"), Palo Verde, and Pennsylvania-New Jersey-Maryland ("PJM").(117) Finally, there are numerous regional reports that publish indices based upon the sales prices and volumes in the region, e.g., over the prior 30 days.(118) A model may develop with informal information gathered on a daily basis (by telephoning key power traders) similar to the Platt's prices for crude oil. These indices, while possibly varying in degrees of reliability, may prove useful for buyers and sellers. Power traders traditionally follow whichever index is most indicative of market conditions in their area and whichever index they agree upon with their customers.

3. Stranded Costs and Tariffs

Power marketers have a distinct competitive advantage over regulated utilities in providing their customers with better prices. Assume the following prices for two utilities:

TABLE 2			
	Peak Production Costs	Off-peak Production Costs	Price offered to customer to cover costs and make profit
Utility 1	5 cents per kWh	3 cents per kWh	4 cents per kWh
Utility 2	5.5 cents per kWh	2 cents per kWh	3.75 cents per kWh

Since a power marketer is not burdened with stranded costs from generation assets, it can combine Utility 1's peak prices with Utility 2's off-peak prices to deliver a rate of only 3.5 cents per kWh, beating the offer of either utility standing alone. On the other hand, power marketers are not immune from legislative tariffs imposed to recover utilities' stranded costs. Thus, when entering contracts with power marketers, price terms must be carefully drafted. For example, a contract that provides a 20% "estimated savings" but contains no contractual savings guarantee may result in only a 5% savings. A contract may also show estimated savings based upon lower payments for electricity transportation. Thus, transportation costs should be expressly included in the contract (especially because they often reflect a stranded-cost-recovery tariff) and should not be included as a pass-through item.

Contracts sometimes contain terms that specify the jurisdiction whose laws will apply to the contract. Often, such terms will provide that the laws of all applicable state and federal regulatory and governmental authorities shall apply. Unfortunately, most states have very rudimentary legislation in place to deal with wholesale or retail wheeling. Thus, contracts are subject to laws that have not yet been passed, or, worse yet, inconsistent provisions that allow different tariffs to be imposed based on the jurisdiction through which the electricity passes (*e.g.*, imposition of stranded costs based on transmission costs, CTC, or other tariffs). The parties, therefore, are forming large contracts that contain, at best, ambiguous price terms and, at worst, huge price exposure. To prevent potential losses, parties should carefully draft price provisions and clarify ambiguities that might include unexpected costs.

B. Quantity Terms

As the provision of electric power in the wholesale market becomes unbundled into separate generation, transmission, and distribution functions, the trading of electric power begins to resemble the trading of other energy commodities: natural gas, oil, refined products, petrochemicals, etc.(119) It would seem logical to assume, therefore, that, as with other energy commodities, the sale of electric power would be treated as the sale of a "good" for legal purposes (including interpretation of the contract). This is particularly true when contracts for the purchase of electric power are unbundled into separate capacity and fixed-rate transmission services. This issue will become important in ascertaining how courts will treat contracts for the sale of unbundled electric power and, consequently, the provisions specifying the quantity sold or purchased under a particular agreement.

Article 2 of the Uniform Commercial Code ("UCC"), dealing with the Sale of Goods, provides particular remedies to buyers and sellers of "goods" for the breach of a contract within its scope.(120) Section 2-105(1) of the UCC defines "goods" as including "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities . . . and things in action."(121) This raises the legal issue of whether contracts (including quantity provisions and remedies) for the purchase and sale of electric power fall within the UCC's Article 2.

It is generally held that electric power is not a good under the UCC's Article 2 when the

electric power is transmitted through a distribution system at a voltage too high for general consumer use.(122) However, courts are split as to whether Article 2 applies to the sale of electricity passed onto a consumer's lines after a transformer has dropped the voltage to a usable level.(123) For example, in New York, electricity is not considered to be a good at all within the meaning of the UCC and Article 2 does not apply directly to contracts involving the provision of electricity.(124) By contrast, the courts in Indiana and California have ruled that the furnishing by a public utility of electrical energy for household use was a sale of goods within the meaning of the UCC's Article 2.(125) Cases from other jurisdictions have reached different results based upon the specific facts of each case. For example, a Maryland court held that electricity in its "raw" state, prior to being placed into a utility's distribution system for household use, was not a good within the meaning of the UCC, but the decision noted that, in some cases, electricity may be considered a good in differing stages of distribution to end-users.(126) In any event, the future trading in the power industry, with purchase and sale agreements of electric power similar to other commodities, may result in the application of Article 2 to these contracts. This is an important issue for determining all aspects of drafting the agreement, including quantity terms.

1. Fixed Amounts

There are no standard power-trading agreements. In fact, such agreements vary broadly, largely in response to the different market conditions throughout the country.(127) Contract terms may include short or long-term provisions that specify quantities within the individual contracts. On the other hand, power traders may enter into negotiated agreements that provide flexibility and allow the parties to address changes in quantities of electric power (for delivery or capacity levels) in a separate letter agreement that is updated at particular intervals.(128) This method of using integrated contract documents, with the initial sales and purchase master agreement setting the basic parameters of the contractual relationship, allows the parties flexibility on both quantity and price terms. Due to the fact that there is no current industry standard quantity term in power-trading contracts, a flexible approach is beneficial to buyers and sellers until market trading units are brought in line with units of futures markets (such as the NYMEX contracts for COB, Palo Verde, and PMJ).(129)

Unlike the fear of scarcity in the natural gas industry during the late 1970s and early 1980s, the dominant mood in the power-trading industry is one of abundant generating capacity in a more competitive market (which may ultimately lead to cheaper electric power on the market). This difference in philosophy is reflected in Order No. 888 by the FERC's stated purpose: "The Commission's goal is to remove impediments to competition in the wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation's electricity consumers."(130) The Order also estimates "quantitative benefits" of approximately "\$3.8 to \$5.4 billion in cost savings."(131) Under these conditions, there is presently little incentive to enter fixed quantity contracts due to the perceived abundance of electricity generating capacity. Under current public utility regulations, generating capacities are about 20% over peak demand loads in the power industry.(132) With increasingly open markets, generating capacity levels may come down, particularly if states' public utility commissions specify lower levels by regulation. Until there is a market perception that there is a shortage of generation capacity, the market incentives that caused the use of take-or-pay clauses in the natural

gas industry will not occur in the electric power-trading industry.

One contract issue looms for the unwary. In the typical sales and purchase master agreement, the parties' separate agreement for price and quantity nominations may be considered a stand-alone contract. In fact, some contracts may expressly stipulate that the separate agreement on pricing and quantity shall be "controlling" in the event of a discrepancy between the two contracts. These clauses should be drafted with precision. While the later agreement on price and quantity may be controlling on these specific terms for the period set forth in the agreement, it should be pointed out in the master agreement (Sales and Purchase Agreement or Interchange Agreement) that the later contract only controls as to those specific items. Other general contract terms (such as force majeure, events of default and remedies, or arbitration provisions) should always be governed by the original and presumably more comprehensive master agreement. Drafting the contracts in this manner may avoid ambiguities that may result in later disputes between the parties.

2. Variable Amounts, Including Requirements and Output Contracts

With the advent of purchase contracts and interchange contracts that require nominations of quantity on a monthly, quarterly, or other basis, there will probably be fewer variable quantity contract terms.⁽¹³³⁾ The parties can simply make nominations for quantities of electricity over a specified term and confirm the agreement in writing.⁽¹³⁴⁾ However, for many end users (particularly with the growth of retail wheeling), a contract with a variable quantity provision may be desirable.

Requirements contracts may offer a method to flexibly specify the quantity of electricity purchased. Before the passage of EPACT and FERC Order No. 888, a number of contracts existed in which utilities entered into requirements contracts with customers. FERC Order No. 888 specifically addresses this issue for contracts within its jurisdiction: "The Final Rule does not generically abrogate existing requirements contracts, but will permit customers and public utilities to seek modification, or termination, of certain existing requirements contracts on a case-by-case basis."⁽¹³⁵⁾ However, retail wheeling agreements at the state level (*i.e.*, contracts that do not fall within the FERC's jurisdiction) may call for new requirements contracts between customers (particularly large-scale industrial and commercial users and aggregators of power purchases) and power sellers (whether utilities or power marketers).⁽¹³⁶⁾ These contracts should be attractive to end-users with high-volume power needs to ensure reliability of supply.⁽¹³⁷⁾ Given that the requirements contracts will no longer be tied solely to cost-based regulatory rates of return, legal interpretation of the contracts may turn upon state law, a novel area for the courts.

The UCC provision on requirements and output contracts states the following:

A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.⁽¹³⁸⁾

For states that consider the sale of electricity to be the sale of "goods," this provision will act as an implied contract provision governing any requirement or output contracts that are entered into between power buyers or sellers.(139) In the natural gas industry, requirements and output contracts have been held valid by the courts.(140) If a power marketer, utility, or independent power producer enters into a requirements contract with an end-user in a deregulated market, Section 2-306 imposes the following legal obligations: (a) that the quantities of power tendered remain reasonably proportionate to stated estimates in the contract or past performance levels and (b) that the seller use best efforts to supply the power and the buyer use best efforts to promote their sale.(141) This section of the UCC should be carefully examined before entering into the "new" type of requirements contracts that may emerge in a deregulated market. Given these legally imposed duties, power buyers and sellers should consider the impact of this provision and how it may affect the provision of firm power(142) under the agreement.

C. Duration (Short-Term, Intermediate, and Long-Term)

To date, no set standard for a power-trading contract's duration has been set in the industry. Power trading contracts that encompass a wide spectrum, i.e., short-term contracts (minutes, hours, weeks), intermediate-range contracts (several months to one year), and long-term contracts (over one year) are appearing in the market.(143) As discussed above, the sellers of electricity, particularly in the wholesale market, are utilizing short-term instruments that often mirror commodities contracts similar to those used in the natural gas industry.(144) Futures contracts traded on the NYMEX are quoted for monthly delivery dates (originally at COB and Palo Verde, and now at PMJ also).(145) These varying practices reflect the transition from a cost-based public utility approach to a deregulated free market approach. As retail wheeling comes into existence, large-scale users (such as industrials, cooperatives, and municipalities) may have more incentive to enter into longer-term agreements, possibly even with the quantity term governed by "requirement" provisions.

For the typical wholesale market contract (a Sales and Purchase Agreement or an Interchange Agreement), the duration is set out by the parties in the initial master agreement.(146) The terms that govern duration of nominations for quantity of electricity are, however, governed by later letter agreements.(147) Parties should consider two points when entering into these agreements. First, as discussed above, a power buyer or seller should be certain to ensure that any later agreements (typically, a confirmation letter on price and quantity terms during a specified time -frame) do not supersede the key provisions of the original, master agreement. Second, the parties should allow a reasonable termination date for the contract upon written notice (such as thirty days) to the other party. This option would allow the parties to renegotiate a contract in the event market or regulatory conditions change to the detriment of one party to the contract. If provisions are made for covering any incidental losses or liquidated damages resulting from early termination, these provisions will allow power buyers and sellers to avoid the possible difficulties of long-term contracting in a rapidly changing environment.

D. Force Majeure Provisions and Firm Supply

One of the most important issues in power- trading contracts is how to ensure that the

contract provides for firm power but also includes a "force majeure" clause to account for factors affecting the delivery of power (or changing conditions) beyond the parties' control.(148) A key question that arises is: How "firm" is firm power in an agreement for the sale and purchase of electricity?(149) Another key question is: How do force majeure clauses govern power-trading contracts if an unforeseen event renders performance impossible or impracticable?

At a minimum, the contract in place in the industry should call for each party to use their best efforts when supplying power under a contract. Despite this fact, interruptions in the generation or transmission of power can affect the fulfillment of obligations under the contract. Typically, these issues are dealt with in two ways: clauses dealing with "default" under the contract with remedies for a breach (discussed below) and force majeure provisions. The scope of this latter provision, the force majeure clause, can have a drastic impact on the contract.

With respect to firm power, many power marketers have associated themselves with trading pools that are implementing standardized contract terms into the power trades made between members.(150) One example is the Western Systems Power Pool Agreement entered into by each member of the Western Systems Power Pool ("WSPP") to promote efficiency in the sale and transmission of electric power in the Western region of the United States.(151) In particular, Service Schedule C to the contract allows for the provision of firm system capacity/energy sales in trades between members of the WSPP. Section C-3 establishes the following guidelines:

A Party may schedule Firm System Capacity/Energy Sale or Exchange Service from another Party by mutual agreement; provided, however, that each Party shall be the sole judge as to the extent to and the conditions under which it is willing to provide or receive such service hereunder consistent with statutory requirements and contractual commitments. Once an agreement is reached, then the obligation for Firm System Capacity/Energy Sale or Exchange Service becomes a firm commitment, for both Parties, for the agreed services and terms.(152)

While this provision is still broad in scope, it represents an attempt to introduce uniformity into power-trading contracts. It is important that the concept of "firm" power (whether energy or capacity) be spelled out in every contract to avoid later disputes.

With respect to force majeure clauses, standard provisions should be placed in power-trading contracts covering events outside of the control of the parties. A force majeure clause gives a party to a contract an excuse for nonperformance in the event it becomes impossible to perform under the contract terms.(153) These situations may develop in power-trading contracts from physical impossibility (such as the inability to obtain or transmit electric power under the contract) or commercial impracticability (changes in the regulatory or market environment). To anticipate these events, force majeure clauses should be an integral part of any power-trading contract. Force majeure clauses should contemplate future physical or commercial conditions in at least several key areas: acts of God or natural disasters, mechanical difficulties in the generation or transmission of electric power, catastrophes of human creation (war, strikes, etc.), and, more importantly, changed market or regulatory conditions. The detail with which events are listed in these

clauses can vary considerably. In the oil and gas industry, force majeure clauses vary in length from fifty words to five or six hundred words.(154)

With the changing regulatory landscape in the regulatory arena, the parties to a power contract should include a force majeure definition that expressly provides for unanticipated events by federal, state, and local governmental or regulatory authorities. Contemplated changes by the FERC and state public utility commissions will lead to rapid changes in the power industry. Contracts drafted in both the wholesale and retail market should anticipate these changes. An example from the natural gas industry demonstrates this point. In *Atlantic Richfield Co. v. ANR Pipeline Co.*,(155) a Texas appellate court affirmed a jury verdict in favor of the natural gas pipeline relieving it of its obligation to perform under a take-or-pay contract due to events of "force majeure" from a governmental order. The court held that FERC Order No. 380, which relieved pipeline customers of the obligation to pay for gas not taken under the contract with the producer applied, as a matter of law, when a force majeure clause was written to account for "laws, orders, rules, regulations, acts or restraints of any government or governmental body or authority, civil or military."(156) In its opinion, the court reasoned that "the parties were at liberty to define force majeure in whatever manner they desired."(157)

Similar situations could potentially develop in the powertrading industry. With the anticipated regulatory changes on the federal level from the FERC (or even Congressional action) and the state level, existing wholesale market contracts may be subject to totally changed conditions. In order to prevent difficulties from litigation due to an adverse and material government ruling, this type of clause (including acts of regulatory or governmental bodies) should be included in the definition of force majeure in a power-trading contract.

In addition, market changes should be contemplated in a force majeure clause. The parties may desire to include or expressly exclude price variations to avoid a claim that an event of "price majeure" has rendered a power-trading contract commercially impracticable. These swings in prices may render it impractical (or unprofitable) for a seller of electric power to provide supplies under the contract in the event the market price rises unexpectedly, and the same problem could confront a buyer in the event the market price falls dramatically. To remedy this situation, the force majeure provision should expressly exclude market or price adjustments as events excusing nonperformance. This may include price adjustments for future tariffs imposed for transmission or imposition of stranded costs. Early contemplation of these issues in the contract may relieve events of default in the dealings between the parties to a power contract.

Finally, two other elements should be included in force majeure contracts. First, a party should not be relieved for events that are within its control or due to its own negligence. Instead, the clauses should expressly provide for an affirmative duty upon each party to use due diligence or best efforts to remedy any unanticipated events. Second, a notification provision should be included. In the event of an unanticipated event (such as a power transmission interruption), notice to the buyer or seller should be required under the contract. This will allow parties to cover potential losses with advance warning of the event of force majeure.

E. Events of Default and Remedies

In a power-trading contract, events of default should be contemplated with regard to failure to deliver electricity, failure to take electricity, or failure to pay. These areas are of the most critical concern in an agreement for the purchase and sale of power. If the contract is governed by the UCC, then specific remedies may be provided as "gap-fillers" in the contract.(158) Nonetheless, specific events of default and remedies, including liquidated damages for a party covering losses incurred by a breach of the contract, should be expressly provided for in a power-trading contract.

The agreement should identify all events of default. It should identify whether contractual remedies will apply for "minor events of default (such as a short-term, limited interruption in supply) or whether termination is appropriate for a "major" event of default (such as repudiation of the contract). For a failure to deliver power by the seller, the buyer should be entitled to cover his losses. Conversely, a failure to take delivery of power by the buyer should entitle the seller to cover his losses. This measure of "liquidated" damages as a direct result of the breach of the contract should include a reasonable, market-based approach. These direct damages can be measured by the fair market cost of replacement or "covering" by buying or selling power to remedy the breach.

The fair market value of damages is measured differently for the buyer and the seller under this standard. For the buyer, it is calculated by subtracting the costs of acquiring power in the market from the contract price. In the case of the seller, it is calculated by subtracting the contract sales price from either the price at which the power not taken is actually sold or the cost at which the power for the contract was acquired or generated.(159) Many industry contracts typically contain such provisions for current wholesale transactions. The parties may also include as "costs" for calculation of liquidated damages the transactional costs, or, in the event of litigation, the attorney's fees involved in remedying the breach.

With regard to failure to pay, the parties can fashion remedies found in commercial contracts for billing and payment that can solve these issues. One unique issue may arise: interest charge on late payments. A party to a power-trading contract should ensure that the interest rate for late payments fixed in the contract does not exceed the lawful amount allowed to be charged as interest in a particular jurisdiction. To do otherwise may be to run afoul of usury statutes imposed by the states.(160) This concern can be addressed by including a savings clause which provides that, "in the alternative, the interest shall not exceed the maximum amount allowed by law" in the applicable jurisdiction.

There are other particular areas of damages that a prudent power trader may wish to address. One such area is that of consequential damages which may potentially be suffered by an end-user of electric power. In the event a seller of electricity is unable to perform the contract and provide power to the buyer, the measure of damages may be contractually limited to include only direct losses from the costs of obtaining alternate power sources. Consequential damages from lost profits or business interruptions must be dealt with in the contract. For a power marketer selling power, the incentive is to exclude such damages from the contract. A buyer of power may wish to retain the option

of recovering such damages. Another area of possible danger from a tort cause of action is punitive damages. This area of damages may be excluded from the contract entirely by an express provision. These issues must be addressed to avoid potential "megalosses" related to power-trading contracts. Not only can damage claims arise from breach of contract, but a power trader must also be wary of potential tort claims (such as tortious interference with contract) which may arise in various jurisdictions. Another means of limiting exposure from these dangers rests in the selection of the forum and governing law in the contract.

F. Choices of Forum and Law

If litigation results regarding a power contract, one of the first and most important choices confronting the non-breaching party is where to seek redress. This includes both the choice of the appropriate forum and the law governing the dispute. As in many other areas involving commercial disputes, there are numerous choices available. First, the parties to a power-trading contract should consider arbitration as an alternative to litigation. Second, if arbitration is not the chosen alternative, a specific forum may be selected for resolution of court disputes. Finally, the parties should specify the law governing the contract. These basic elements should be inherent in any major commercial transaction. The rapid pace of trading in electric power, however, can often lead to an oversight in adding these provisions to a contract.

1. Arbitration Provisions

For contracts involving the movement of goods in interstate commerce, the terms of the Federal Arbitration Act will govern enforcement of an arbitration clause in the contract.(161) The provisions of the Federal Arbitration Act apply to all contracts evidencing transactions in interstate commerce.(162) The United States Supreme Court has uniformly applied the Act as evidencing a "congressional declaration of a liberal federal policy favoring arbitration agreements."(163) Given that most wholesale power trades will inevitably involve interstate commerce, the provision of the Federal Arbitration Act should allow for enforcement of arbitration provisions. In addition, individual states often have enacted Arbitration Acts modeled after the federal act.

The arbitration clause allows for resolution by a panel of arbitrators, either picked by the parties or an outside entity, to resolve the dispute rather than going through a protracted expensive court proceeding. These provisions offer the advantage of allowing the parties to bring experienced industry personnel, former members of the judiciary, or distinguished members of the bar to resolve a dispute. A potential downside to arbitration is the possible undue speed of the procedure and the lack of an appellate remedy absent a showing of fraud, duress, or undue influence of the arbitrator.

There are a number of available alternatives when drafting arbitration clauses. The American Arbitration Association offers information on drafting arbitration clauses for commercial disputes that may provide a reference.(164) In addition, the parties may chose to conduct the arbitration with arbitrators picked by the parties (jointly), with a panel (perhaps one selected by each party and a neutral arbitrator then elected), or by a governing body in the electric power industry. Many alternatives are available to streamline future contractual disputes.

One difficulty may arise in the structure of current powertrading contracts. If a master agreement is executed with later agreements to be executed between the parties, the master agreement should be carefully drafted to ensure that the arbitration provision applies to the future contracts. In at least one federal case⁽¹⁶⁵⁾ involving take-or-pay disputes, the existence of gas purchase agreements with arbitration clauses side-by-side with other documents (without arbitration clauses) ultimately resulted in chaos. Parallel litigation and arbitration proceedings took place, but the federal courts ultimately ruled that the arbitration provisions did not govern the dispute.⁽¹⁶⁶⁾ This type of difficulty can be avoided by careful drafting with regard to any superseding agreements. The fact that the arbitration provision governs any and all agreements between the parties, including any other letters or later documents evidencing nominations of price, quantity, and duration of electric power purchases and sales should be clearly stated in the contract.

2. Choice of Forum

In the event that an arbitration provision is not included in the contract, the parties may consider a choice of forum provision. Such a provision specifically designates the place in which a lawsuit must be filed.⁽¹⁶⁷⁾ Again, this will add a degree of certainty to the resolution of the dispute and may impact the applicable law in some states.

3. Choice of Law

A provision should also be included in every power-trading agreement regarding choice of the governing law (regardless of whether the contract is to be enforced by arbitration or litigation). For any contract that is outside of the FERC's jurisdiction, issues may arise involving interpretation of several states' contract laws (including the provisions of the states' versions of the UCC if held to apply to the sale of electricity). Failure to include such a provision will raise two problems: first, uncertainty as to the governing principles of law for the contract and, second, the forum in which a dispute will be litigated if necessary. Often, a suit may be filed (or transferred by motion of a party) to the jurisdiction whose law governs the agreement if other factors make the selected state a proper forum.

To eliminate these uncertainties, every power-trading contract clause should contain a simple provision: a choice of law clause. The form does not necessarily matter,⁽¹⁶⁸⁾ but the issue is important. Designation of the law of a particular state can impact such issues as whether the UCC governs the contract remedies and damages recoverable in the event of a breach; recovery of punitive damages and applicable limitations on such remedy; recovery of costs; and, importantly, attorney's fees. This must be determined for each contract depending upon the nature and physical location of the transaction.

V. CONCLUSION

This article has attempted to address the issues that will face power buyers and sellers when dealing with a newly-deregulated and competitive market. The wholesale market for power trading is already operating. The retail markets will appear, on a state-by-state basis, over the course of a number of years. For both of these types of markets, however, the central theme is the same: **POWER BUYERS AND SELLERS SHOULD WORK**

TO DEVELOP FIRM POWER PURCHASE AND SALE AGREEMENTS THAT ENSURE RELIABLE SUPPLIES OF POWER AT MARKET- BASED PRICES. It may take time for each individual power buyer or seller to devise its own contract to attempt to "standardize" contract terms in the industry. Nevertheless, the experience in the natural gas industry and the emerging contracts in the wholesale market are both useful starting points for finding meaningful solutions.

In the absence of a national standard, whether imposed by governmental regulations or the cooperative efforts of members of the electric power industry, these contract issues may vary from region to region. Undoubtedly, group efforts to standardize contract terms, such as the Western Systems Power Pool Contract, will emerge in the future. These standardized contracts will assist buyers and sellers in focusing on the negotiation of agreements. The ultimate issue, however, will be whether future contracts shaped in the power industry will provide flexible and workable alternatives for resolving disputes. The alternative is the testing of these contracts in the crucible of litigation.

Footnotes:

(1)*Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Service by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Final Rule, Order No. 888, 61 Fed. Reg. 21540 (May 10, 1996) (hereinafter referred to as "Order No. 888") The FERC's goal in issuing Order No. 888 was to "remove impediments to competition in the wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation's electricity consumers," *Id.* at 21540

(2)Wholesale wheeling is defined as transferring power between two utility providers, whereas retail wheeling is defined as transferring the power from a provider to a customer. John F. Lomax, Jr., *Comment, Future Electric Utility Bankruptcies: Are they on the Horizon and What Can We Learn From Public Service Co. of New Hampshire's Experience?*, BANK. DEV. J. 535, 543 (1996). Full retail wheeling would allow consumers to chose their own utility provider much the same way phone service is provided today. *Id.* at 543-44.

(3)Order No. 888, 61 Fed. Reg. at 21541.

(4)A take-or-pay provision is a clause in a natural gas contract that requires the natural gas pipeline (as buyer) to pay the producer (as seller) for a certain minimum volume of gas each year, usually based on the deliverability of the producer's wells, whether the gas is actually taken or not during the contract period.

(5)*See, e.g., Atlantic Richfield Co. v. ANR Pipeline Co.*, 768 S.W. 2d 777 (Tex. App. - Houston [14th Dist.] 1989, *no writ*).

(6)Construction of capital intensive utility baseload plants in the 1970s resulted from an expectation of increased demand for power combined with traditional utility rate regulation that awards a rate of return on approved investments - the "rate base." For a number of utilities, growth never occurred because of conservation and economic downturns. This resulted in those utilities having excess capacity and nowhere to sell it. *See* Richard J. Pierce, Jr., *The Regulatory Treatment of Mistakes in Retrospect: Cancelled Plants and Excess Capacity*, 132 U. PA. L. REV. 497, 503 (1984). Inflation

and high interest rates in the United States dramatically increased the costs of these plants and, as a result, increased the rates charged to consumers. Bernard S. Black & Richard J. Pierce, Jr., *The Choice Between Markets and Central Planning in Regulating the U.S. Electricity Industry*, 93 COL. L. REV. 1339, 1346 (1993). The FERC's deregulation of the wholesale power industry was an effort to lower consumer costs by stimulating competition in the marketplace. *See supra* note 1 and accompanying text. FERC Order No. 888 allows for the modification or termination of current requirements contracts that will have discriminatory pricing provisions because of the power deregulation. Order No. 888, 61 Fed. Reg. at 21541. This should help the utilities and their customers address and avoid the same type of costly issues litigated in the natural gas industry. *See* Stephen A. Dansky, *Deregulation and The End of Project Financing*, FORT., July 15, 1994, at 18.

(7) Power marketers actually take title to the electricity when they buy it. Power brokers take no title to the power, but rather match-up prospective buyers and sellers. Citizens Energy Corporation, 35 FERC ¶ 61, 198 (1986).

(8) Stranded costs refers to the investment that utility companies made under regulation, for capacity built to serve ratepayers that will no longer be profitable to sell in the new, competitive deregulated market. Bernays T. Barclay, *Notes from Outside Counsel*, ENERGY BUYER'S GUIDE, Nov. 1996, at 6. The method for determining the amount of recovery associated with Stranded cost is a major point of contention in the states that are moving toward retail wheeling of electric power. Michael Totty, *Competition in Electric Industry May Have Huge Costs for Utilities*, WALL ST.J., July 1, 1996, at T1.

(9) *Capacity Reservation Open Access Transmission Tariffs, Notice of Proposed Rulemaking*, (Docket No. RM96-11-000), FERC Stats. & Regs. ¶ 32517, May 1996.

(10) *See generally* Roland, Comment, *Take-or-Pay Provisions: Major Problems for the Natural Gas Industry*, 18 ST. MARY'S L.J. 251 (1986)

(11) *Id.*

(12) 15 U.S.C. §§ 3301-3432 (1982).

(13) *See* Maryland People's Counsel v. FERC, 761 F.2d 768, 771 (D.C. Cir. 1985).

(14) *See* Department of Energy/Energy Information Administration, NATURAL GAS MONTHLY (Mar. 1984) at 29

(15) *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No. 500-H, 53 Fed. Reg. 52344, 52356 (1989).

(16) *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No. 500, 52 Fed. Reg. 30344 (1987).

(17) *Elimination of Variable Costs From Certain Natural Gas Pipeline Minimum Commodity Bill Provisions*, Order No. 380, 49 Fed. Reg. 22778, 22789 (1984).

(18) *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations; and Regulation of Natural Gas*

Pipelines After Partial Wellhead Decontrol, Order No. 636, 57 Fed. Reg. 13267- 13270 (Apr. 16, 1992).

(19)*Id.* at 30393-94, 30402-04.

(20)Typical minimum take-or-pay requirements were 80 - 90% of a well's delivery capacity for a contract. *Universal Resources Corp. v. Panhandle Eastern Pipe Line Co.*, 813 F.2d 77, 78 n.2 (5th Cir. 1987).

(21)*Koch Hydrocarbon Co. v. MDU Resources Group, Inc.*, 988 F.2d 1529, 1532 (8th Cir. 1993).

(22)*See generally* *supra* notes 4-6 and accompanying text.

(23)Order No. 380, 49 Fed. Reg. at 22778-22789 (relieving the natural gas pipeline's customers of the obligation to pay for gas that was not taken under take-or-pay clauses).

(24)Order No. 636, 57 Fed. Reg. at 13269

(25)25. 925 S.W.2d 565, 570-71 (Tex. 1996).

(26)Christine Strobel, *The Power to Change: Retail Pilot Programs in Six States are Allowing Customers to Choose Their Power Supplier. What Have They Learned?*, ENERGY BUYER'S GUIDE Nov. 1996, at 15.

(27)Barbara Saunders, *Oil / Gas Firms Take Lead Among New Breed Of Energy Megamarketers. (Power Deregulation Allows Oil and Gas Players to Sell Electricity Wholesale)*, Oil & Gas J., Sept. 16, 1996, available in 1996 WL 8288144.

(28)16 U.S.C.A. § 796(17)-(18) (West 1997) (defining Qualifying Facilities); 18 C.F.R. § 292.203 (1997) (setting forth the requirements for qualification); 18 C.F.R. § 292.304 (1997) (requiring utilities to buy power from Qualifying Facilities).

(29)Saunders, *supra* note 27.

(30) *Id.* Power marketers are permitted to own a relatively small portion of the electricity that is available for sale in the market.

(31)Market and industry statistics are infrequently published because of the FERC's limited reporting requirements. The authors obtained much of the quoted market size information from a variety of sources, but principally from survey results that were reported in the Oil & Gas Journal. *See* Saunders, *supra* note 27.

(32)*Id.*

(33) *EEL, Members Changing To 'Get The Rules Right'*, ELEC.UTIL., BUS. & FIN., Mar. 3, 1997, available in 1997 WL 10057575.

(34)*Id.*

(35) *Marketers Top 200 Million Mwh in Sales; on Track to Break a Million Mwh in 1997*, Aug. 18, 1997, available in 1997 WL 9114634.

(36)*Id.*

(37)Saunders, *supra* note 27.

(38)*Id.*

(39)*Id.*

(40) *Power Marketers Ranked by Sales - 1995*, POWER MARKETS WK., Feb. 26, 1996, available in 1996 WL 9659286.

(41)*Power Marketr's Ranked by Sales - 1996*, POWER MARKETS WK., Mar. 3, 1997, available in 1997 WL 9114025.

(42) *Marketers Top 200 Million Mwh in Sales; on Track to Break a Billion Mwh in 1997*, POWER MARKETS WK., Aug. 18, 1997, available in 1997 WL 9114634

(43)Currently, the FERC does not have the authority to mandate retail power wheeling, and the issue is left up to individual states. Saunders, *supra* note 27. Some states, such as California, are moving in the direction of retail competition.

(44)Order No. 888, 61 Fed. Reg. at 21541, 21591 (OASIS is supposed to make information available to all customers and potential customers, and so to ensure that companies do not unfairly deny access by misuse of their ownership, operation, or control of power transmission.).

(45)Saunders, *supra* note 27.

(46)*Id.*

(47)Christene Strobel, *Customers First, Profit Second, American Energy Service Corp. Offers Customers More Upside from Financial Energy Trading*, ENERGY BUYER'S GUIDE Nov. 1996 at 25.

(48)Mark E. Haedicke, *Competitive-Based Contracts For The New Power Business*, 17 Energy L.J. 103, 117-18 (1996).

(49)*See supra* note 8 and accompanying text.

(50)Order No. 888, 61 Fed. Reg. at 21549.

(51)Holmes W. Jenkins, Jr., *Electricity Producers Run Screaming from Reality*, WALL ST. J., May 14, 1996, at A19.

(52)Order No. 888, 61 Fed. Reg. at 21628.

(53)*Id.*

(54)*Id.*

(55)*Id.* at 21630.

(56)*Id.* at 21557.

(57)*Id.* at 21639.

(58)*Id.*

(59)*Id.* at 21557.

(60)*Id.* at 21639.

(61)*Id.* at 21664.

(62) *Id.* at 21639.

(63)*Id.* at 21639-40.

(64)*Id.* at 21639.

(65)*Id.* at 21542.

(66)A public utility is any person or corporation that owns or operates facilities used for the transmission of electric energy in interstate commerce or the sale of electric energy at wholesale in interstate commerce. 16 U.S.C.A. § 824(d)-(e) (West 1997).

(67)Power pools consist of regional utility members who defer to a central dispatcher who then turns to each plant, regardless of the owner, in a merit-based order of increasing cost until demand is filled. This assures the least cost dispatched to consumers. Robert Blohm, *Don't give Utilities a Monopoly on Power*, WALL ST. J., Mar. 11, 1997, available in 1997 WL-WSJ 2412447.

(68)Examples of entities that do not fall within the FERC's direct jurisdiction include municipalities, co-ops, public utilities that do not own transmission lines (such as non-utility generators ("NUGS") and marketers), and government-owned power marketing administrations.

(69)Order No. 888, 61 Fed. Reg. at 21542.

(70)*Id.*

(71)Michael Davis, *Californians in the Dark About Electric Power*, HOUS. CHRON., Dec. 30, 1997, at A1.

(72) *Id.* at 21613-14.

(73)*Report Of The Committee on Electric Utility Regulation*, 18 ENERGY L.J. 197, 211 (1997)

(74)*Id.*

(75)*PG&E Wins Interim Stranded-Investment Charge To Impose on Department Customers*, ELEC. UTIL. UK., apr. 15, 1996, available in 1996 WL 8595838.

(76) *California: Consumers Can Expect Lower Energy Rates Under Deregulation Bill*, WEST'S LEGAL NEWS, Sept. 11, 1996, available in 1996 WL 510546; see also *supra* note 71 at A10.

(77)*Gov. Wilson Signs Calif. Deregulation Bill; Legislation Seen a Boon to Industry*, Indus. Energy Bull, Oct. 4, 1996, available in 1996 WL13589412.

(78)*Id.*

(79)*CPUC Okays Sell-Off of 12,000-Plus Mw; Bond Opponents May Try Voter Initiative*, POWER MARKETS WK., Sept. 8, 1997, available in 1997 WL 9114729.

(80)*Id.*

(81)*Tiny Rhode Island Unveils Big Customer-Choice Plans*, Power Reg. Monitor, Aug. 19, 1996, available in 1996 WL 15857934.

(82)*Id.*

(83)*Id.*

(84)*Report Of The Committee On Electric Utility Regulation*, *supra* note 73, at 216- 17.

(85)*Quick Passage Seen For Restructuring Bill in Rhode Island; Has NEES Support*, ELEC. UTIL. Wk., February 12, 1996, available in 1996 WL 8595529.

(86) *Report Of The Committee On Electric Utility Regulation*, *supra* note 73, at 216.

(87)*Id.*

(88)*Id.*

(89)*Id.*

(90)*Id.*

(91)*Pennsylvania Becomes Fourth To Enact Dereg Legislation*, STATE REG. POWER MONITOR, Dec. 9, 1996, available in 1996 WL 15858289.

(92)*Plan By Mass. Governor Encourages Utility Sales of Generating Assets*, ELEC. UTIL. UK., Feb. 19, 1996, available in 1996 WL 8595572.

(93)*Id.*

(94)*Id.*

(95)Texas Consumer Power Act of 1997, H.B. 1509, sec. 12, § 2.402, 75th Leg., R.S. (1997).

(96)*Id.*

(97)Michael Davis, *Co-Ops Put Power Bill's Fate in Doubt/Rural Services Oppose Texas Proposal*, HOUS. CHRON., May 20, 1997, available in 1997 WL 6557769.

(98)Texas Consumer Power Act of 1997, *supra* note 95.

(99) Michael Davis, *Powering Up-Texas Committee Needs to Devise Electricity Plan*, DALLAS MORNING NEWS, Sept. 30, 1997, available in 1997 WL 11524478.

(100)*Electric Restructuring Could Falter in Vermont Legislature*, CAP. MARKETS REP., Jan. 22, 1997.

(101)*Oklahoma Bill Takes First Step Toward Establishing Retail Competition by 1999*, ELEC. UTIL. UK., Feb. 10, 1997, available in 1997 WL 9122494; *PGE Files Restructuring Plan Targeting Retail Access for All Users by Oct. 1998*, ELEC. UTIL. UK., Sept. 8, 1997, available in 1997 WL 9123431.

(102)TEX. UTIL. CODE. ANN. § 31.001 (Vernon Supp. 1998).

(103)In an article in the *Houston Business Journal*, Vol. 26, No. 41, Week of February 28-March 6, 1997, at p. 1, the author (along with market analysts) predict that "Houston is rapidly becoming the trading hub for another commodity - electric power." One analyst is quoted as predicting that "Houston will be the center of electricity for the country." *Id.* While this information is not intended to reflect on the Texas penchant for self-promotion, it does highlight the fact that power- trading contracts made in Texas may be subject to Texas law.

(104)In the wholesale market, the buyers may be utilities buying extra power to cover peak loads, municipalities, electric cooperatives, independent power producers, or power marketers. The sellers may be utilities, independent power producers, non- utility generators, or - again - power marketers. Currently, there are also power brokers in the middle (who do not actually take title to the power.) Obviously, the buyers will significantly change as retail wheeling emerges. The range will include large-scale purchasers, such as industrial customers, commercial users, and power aggregators who pool demand from smaller industrial customers, commercial users, and power aggregators who pool demand from smaller industrial, commercial, or even residential users. At the smaller-scale end of the spectrum will be ordinary residential users and smaller commercial businesses.

(105)A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty. RESTATEMENT (SECOND) OF CONTRACTS §1 (1981).

(106)These considerations did not exist under the old industry structure because vertically-integrated monopolies were given franchise rights to territories and sold power on a cost-to-produce basis with a

regulated rate of return. This is rapidly becoming an anachronism. Linda Jones, *Electric Industry Restructuring - Consumers Will Soon Choose Electrical Supplier*, 40 *Advoc. (Idaho)* 30, 31 (June 1997).

(107)The efficient breach doctrine provides that if breaching the contract is economically advantageous for one party, the law should not deter the breach. Lee Shidlofsky, Comment, *The Changing Face of First-Party Bad Faith Claims in Texas*, 50 *SMU L. Rev.* 867, 892 (1997).

(108) *See supra* note 10.

(109)In some rare circumstances, courts have held that the changed regulatory and market conditions were events of "force majeure" under gas purchase agreements. *See, e.g., Atlantic Richfield Co. v. ANR Pipeline Co.*, 768 S.W.2d 777 (Tex. App.--Houston [14th Dist.] 1989, *no writ*). This area is discussed below in the section regarding force majeure clauses in power-trading contracts.

(110)Haedicke, *supra* note 48, at 118.

(111) *Fitch Responds to New Power Market*, *Elec. Util. Bus. & Fin.*, Apr. 8, 1996, available in 1996 WL 15662532.

(112)For example, the city of Dover, Delaware contracted with Duke/Louis Dreyfus to operate Dover's power system and sell energy and capacity for a fixed price over a 10.5 year term. *Duke, Louis Dreyfus Pair Up*, *Gas Daily*, Mar. 15, 1996, available in 1996 WL 8790687.

(113)Michael T. Maloney et al., *Stranded-Cost Recovery: All FERC'ed Up*, *PUB. UTIL. FORT.*, Nov. 16, 1996, at 42, 43.

(114)Market indices for electric power include the New York Mercantile Exchange ("NYMEX") options for delivery at California-Oregon Border ("COB") and Pennsylvania-New Jersey-Maryland ("PJM"). *AT NYMEX Debates Fixed Vs. Variable Issue; Committee to Vote on Futures Nov. 24*, *POWER MARKETS WK.*, Nov. 17, 1997, available in 1997 WL 15672037.

(115)*Duke, Louis Dreyfus Pair Up, supra* note 112.

(116)Robert McCullough, *Trading on The Index: Spot Markets and Price Spreads in The Western Interconnection*, *PUB. UTIL. FORT.*, Oct. 1, 1996, available in 1996 WL 9280240.

(117)*Id.*

(118)*Id.*

(119)*Id.* A futures contract is a firm commitment to deliver or receive a specified quantity and type of a commodity at a specific location within a designated period. Typically, prices are not predetermined, but there are penalties for nonperformance. Preston D. Head, *Why Use Futures Contracts?*, *ELEC. WORLD*, Jan. 1, 1996, available in 1996 WL 8695445.

(120)McCullough, *supra* note 116; *see also supra* note 114.

(121)*Id.*

(122)Haedicke, *supra* note 48 at 113.

(123)U.C.C. § 2-102 (West 1997).

(124)U.C.C. § 2-105(1) (West 1997).

(125) *See, e.g.*, Navarro County Elec. Coop., Inc. v. Prince, 640 S.W.2d 398, 400 (Tex. App.-Waco 1982, *no writ*) (holding that transmission of electrical energy along high-tension power lines, which eventually lead into transformers, is not a "good" within the meaning of the statute governing the implied warranty of merchantability); see also Mancuso v. Southern Cal. Edison Co., 232 Cal. App. 3d 88, 100, 283 Cal. Rptr. 300 (2d Dist. Div. 3 1991).

(126) *See* Gary D. Spivey, Annotation, *Electricity, Gas, or Water Furnished by Public Utility As "Goods" Within Provisions of Uniform Commercial Code, Article 2 on Sales*, 48 A.L.R. 1060 (1996) (discussing the few cases that have construed the issue of whether the furnishing of electricity by a public utility constituted a sale of goods under Article 2).

(127)United States v. Consolidated Edison Co. Of N.Y., Inc., 590 F. Supp. 266, 269 (S.D. N.Y. 1984), (citing Farina v. Niagara Mohawk Power Corp., 438 N.Y.S.2d 645 (App. Div. 3d Dept. 1981); see also Williams v. Detroit Edison Co., 234 N.W.2d 702, 705 (Mich. Ct. App., 1975); Buckeye Union Fire Ins. Co. v. Detroit Edison Co., 196 N.W.2d 316, 317 (Mich. Ct. App. 1972).

(128)Helvey v. Wabash County REMC, 278 N.E.2d 608, 609-10 (Ind. Ct. App. 1972) (analyzing application of section 2-105 definition of "goods" to electricity); Pierce v. Pacific Gas & Elec. Co., 212 Cal. Rptr. 283, 294 n.12 (Ct. App. 1985) (holding that once electricity is at a marketable voltage, it is a product and, thus, a good).

(129)Singer Co. v. Baltimore Gas & Elec. Co., 558 A.2d 419 (Md. Ct. Spec. App. 1988) (reviewing reported decisions from other jurisdictions on the application of Article 2 to the sale of electricity).

(130)Haedicke, *supra* note 48 at 117.

(131) *Id.* at 118.

(132)McCullough, *supra* note 116.

(133)Order No. 888, 61 Fed. Reg. at 21540.

(134) *Id.* at 21541.

(135)Philip Hanser et. al., *Real-Time Pricing - Restructuring's Big Bang?*, PUB. UTIL. FORT., Mar. 1, 1997, available in 1997 WL 9989190.

(136)*See generally* Haedicke, *supra* note 48 at 126.

(137)*Id.*

(138)Order No. 888, 61 Fed. Reg. at 21540-41.

(139)William H Miller, *Electrifying Momentum*, INDUSTRY WK., Feb. 17, 1997, available in 1997 WL 8230906.

(140)*Id.*

(141)U.C.C. § 2-306(1) (West 1997).

(142)Even in jurisdictions which hold that the UCC does not apply to a particular contract (such as the application of Article 2 to the sale of electricity), the courts often use the UCC as a guide for the common law interpretation of similar contract provisions. *See, e.g.*, *United States v. Consolidated Edison Co. Of N.Y.*, 590 F. Supp. 266, 269 (S.D. N.Y. 1984) (the New York courts have drawn upon the UCC reservation of rights provision in areas to which the Code does not expressly apply). With power-trading contracts resembling commodities exchanges, courts could easily rely upon UCC provisions by analogy despite holdings that the UCC does not expressly apply to the sale of electricity.

(143)*See United States v. Great Plains Gasification Assocs.*, 819 F.2d 831 (8th Cir. 1987) (holding that output contract for plant producing synthetic natural gas from lignite was enforceable).

(144)U.C.C. § 2-306 (West 1997). The Comments to Section 2-306 of the UCC provide guidance to the interpretation of requirements and output contracts - including the statement that an agreed quantity estimate "is to be regarded as a center around which the parties intend the variation [in power supplies] to occur." U.C.C. § 2-306 cmt. 3 (West 1997).

(145)"Firm power" is energy that is contractually sold and commits the provider to make a certain amount of power available for some defined time period. PUBLIC UTILITY COMMISSION OF TEXAS, ELECTRIC POWER INDUSTRY SCOPE OF COMPETITION AND STRANDED INVESTMENT REPORT, 75th Leg., R.S. (1997).

(146)Haedicke, *supra* note 48 at 117.

(147)*Id.*

(148)McCullough, *supra* note 116.

(149)Haedicke, *supra* note 48 at 117-18.

(150)*Id.*

(151)*Id.* at 120-21.

(152) *Id.* at 117.

(153)Strobel, *supra* note 47.

(154)*WSPP Moves to Clarify Financial Firm; Traders See Limited Impact on Market*, POWER MARKETS WK., Aug. 25, 1997, available in 1997 WL 9114678.

(155)WSPP Agreement, effective as of December 27, 1995, Schedule C at pp. C-1, C-2.

(156)See P. Declercq, *Modern Analysis of The Legal Effect of Force Majeure Clauses in Situations of Commercial Impracticability*, 15 J.L. & Com. 213 (1995) (discussing force majeure clauses in commercial contracts).

(157)A detailed discussion for reference purposes on the use of these clauses in the oil and gas industry is provided in 4 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW §§ 683.1-.4 (Matthew Bender 1997).

(158)768 S.W.2d 777 (Tex. App.-Houston [14th Dist.] 1989, *no writ*).

(159)*Id.* at 780-81.

(160) *Id.* at 781.

(161)For example, section 2-703 provides for "Seller's Remedies in General," and section 2-711 provides for "Buyer's Remedies in General." U.C.C. §§ 2-703, 2-711 (West 1997). These provisions are intended to fill the gaps in contracts assuming, of course, that the applicable state's courts hold that Article 2 applies to a contract for the purchase and sale of electricity.

(162)One commentator has suggested that the traditional methods for calculating damages by determining the difference between the contract price and some current index price may not provide an adequate remedy in a deregulated market. He suggests that if a power contract transaction is hedged and the other party does not perform, the breaching party should be required to buy a replacement contract. The cost for this replacement contract should be determined based upon projected price curves rather than the cost based upon some index price on a particular day. If a replacement contract is not viable, then a termination payment should be made to the non-defaulting party. This payment should look to the present value of all the transactions that were terminated, and should include any associated replacement costs as well. These methods for damages should be included as provisions in the power contract in order to adequately protect the non-defaulting party's position. Haedicke, *supra* note 48 at 123.

(163)For example, the Texas usury statute is set forth at TEX. FIN. CODE ANN. § 305.004 (Vernon 1997).

(164)9 U.S.C.A. §§ 1-16 (West 1997).

(165)See *Perry v. Thomas*, 482 U.S. 483 (1987).

(166)See *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1982).

(167)See AMERICAN ARBITRATION ASSOCIATION, DRAFTING DISPUTE RESOLUTION CLAUSES - A PRACTICAL GUIDE (1993). The Association also provides rules for arbitrations conducted under its auspices if this method is selected by the parties.

(168)*Dakota Gasification Co. v. Natural Gas Pipeline Co. of America*, 964 F.2d 732 (8th Cir. 1992).