

2012

## **A Precedent Built on Sand: *NorCon v. Niagara Mohawk***

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### **Recommended Citation**

Victor P. Goldberg, *A Precedent Built on Sand: NorCon v. Niagara Mohawk*, COLUMBIA BUSINESS LAW REVIEW, VOL. 2013, P. 38, 2013; COLUMBIA LAW & ECONOMICS WORKING PAPER No. 423 (2012).  
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**Working Paper No. 423**

**June 28, 2012**

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## A Precedent Built on Sand: *NorCon v. Niagara Mohawk*

Victor P. Goldberg<sup>1</sup>

Suppose that A has entered into a contract with B, but B comes to believe that A will not perform. What can B do? It could perform its obligation, and, if A did indeed fail to perform, it could pursue its legal remedies. This might not be a very attractive option if the costs of going to court were high and there was a reasonable likelihood that B would not be able to collect part, or all, of the judgment. It could treat A as a breacher and withhold its performance; it would, however, run the risk that a court might find that B, not A, had breached. It could demand assurance from A that it would perform. The common law did not give B that right, with one exception. If A were insolvent, B could suspend performance or insist upon a cash payment. Otherwise, absent language in the contract or A's acknowledging its unwillingness to perform (an anticipatory repudiation), B was faced with this awkward choice.

The UCC §2-609 expanded the insecure B's options by allowing it to demand "adequate assurance" if it had reasonable grounds for believing that A would not perform. But what if the contract were not governed by the UCC? The Restatement (Second) extrapolated from the UCC and recognized a right to demand adequate assurance in contract disputes not involving goods. (It was really sort of a [P]Restatement since the drafters had no precedent outside the UCC):

(1) Where reasonable grounds arise to believe that the obligor will commit a breach by non-performance that would of itself give the obligee a claim for damages for total breach, . . . the obligee may demand adequate assurance of due performance and may, if reasonable, suspend any performance for which he has not already received the agreed exchange until he receives such assurance.

(2) The obligee may treat as a repudiation the obligor's failure to provide within a reasonable time such assurance of due performance as is adequate in the circumstances of the particular case.<sup>2</sup>

The issue arose in a federal case applying New York law—*NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp.*<sup>3</sup> The Second Circuit sent the following certified question to the New York Court of Appeals: "Does a party have the right to demand adequate assurance of future performance when reasonable grounds arise to believe that the other party will commit a breach by non-performance of a contract governed by New York law, where the other party is solvent and the contract is not governed by the U.C.C.?" The court could simply have said that we adopt the enlightened reasoning of the Restatement. That might not have been the wisest policy, but the decision would have been unassailable. However, after a lengthy exegesis on the

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<sup>1</sup> Conflict of interest statement: The expert witness for Niagara Mohawk in this case was Eugene Meehan of NERA. I am an outside consultant to NERA. I was not associated with NERA when the initial report was made, but I was associated with the firm when the case was tried in 1999. I had no knowledge of NERA's involvement until after I had completed a first draft. After reading an early draft of this paper, Dr. Meehan provided me with some information from his files and with some insights regarding the contract and the regulatory context.

<sup>2</sup> Section 251.

<sup>3</sup> 110 F.3d 6, 32 UCC Rep.Serv.2d 833.

merits of that position, the court chose a more nuanced position. It narrowed the question, making much of the incremental, interstitial method of common law adjudication.

We conclude, therefore, that it is unnecessary, while fulfilling the important and useful certification role, to promulgate so sweeping a change and proposition in contract law, as has been sought, in one dramatic promulgation. That approach might clash with our customary incremental common-law developmental process, rooted in particular fact patterns and keener wisdom acquired through observations of empirical application of a proportioned, less than absolute, rule in future cases.

\* \* \*

Experience and patience thus offer a more secure and realistic path to a better and fairer rule, in theory and in practical application. Therefore, this Court chooses to take the traditionally subtler approach, consistent with the proven benefits of the maturation process of the common law, including in the very area of anticipatory repudiation which spawns this relatively newer demand for assurance corollary.<sup>4</sup>

The nuanced approach would be guided by the facts of the specific case, with future cases fleshing out the contours of the right. That sounds great. We don't have to rely on the example of the UCC or the authority of the Restatement and its distinguished chief reporter, Allan Farnsworth. Following this strategy (or, more precisely, claiming to follow this strategy) the court extended the right to demand assurance, but only for a subset of disputes. It was "now persuaded that the policies underlying the UCC 2-609 counterpart should apply with similar cogency for the resolution of *this kind of controversy*."<sup>5</sup> The type of controversy is spelled out later in the opinion: "It should apply to the type of long-term commercial contract between corporate entities . . . which is complex and not reasonably susceptible of all security features being anticipated, bargained for and incorporated in the original contract."<sup>6</sup>

There is one big problem with this conclusion. There is nothing in the opinion that would suggest why this kind of controversy should be singled out. What, in particular, does the court mean when it says that security features could not be anticipated in the original contract? Perhaps, I thought, the district court's opinion might shed some light on the question. It did, but not in the way I had anticipated. Judge Sprizzo noted that the contract did deal with the security issue. If NorCon failed to perform, Niagara Mohawk would have a lien on its plant.<sup>7</sup> Perhaps Sprizzo mischaracterized the assurance embodied in the contract. Wrong. Indeed, if anything, he understated the contractual assurance afforded Niagara Mohawk.

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<sup>4</sup> *Norcon*, 705 N.E.2d at 662.

<sup>5</sup> *Id.* Emphasis added.

<sup>6</sup> *Id.*

<sup>7</sup> "To secure this risk, the parties negotiated and agreed to a provision in the Encogen Agreement granting Niagara Mohawk a security interest in the Encogen Facility to secure Encogen's performance and any balance in the adjustment account remaining at the end of the third period." *Encogen Four Partners, L.P. v. Niagara Mohawk Power Corp.*, 914 F.Supp. 57, 59 (S.D.N.Y. 1996) *vacated sum nom.* *Norcon Power Partners, L.P. v. Niagara Mohawk Power Corp.*, 163 F.3d 153 (2d Cir. 1998) *Encogen and NorCon* were similarly situated non-utility generators (NUG's). The initial suit was in Encogen's name. The appeal and subsequent litigation concerned NorCon.

This struck me as odd. Why would a court go out of its way to find a right to demand assurance when the contracting parties appear to have negotiated a term to deal with this problem? The disconnect, I surmised, must have arisen from the certification process—the question was acontextual and, I thought, perhaps the court had no knowledge of the context. Wrong again. In fact, the briefs included detailed specifics about the contract and its context, including some of the negotiating history regarding the assurance.<sup>8</sup>

There is no way to get from the particular facts of this case to the broad question certified to the New York court or to the narrower question the court answered. The court could, as I noted, have answered the certified question without regard to the *NorCon*-Niagara Mohawk dispute; the judges were only being asked for a statement of the law. But it didn't. It presented some of the facts and then leapt to a conclusion implying that the conclusion bore some relationship to the stated facts (*this* kind of controversy). If the *NorCon* facts are irrelevant, then the court provides no basis for its conclusion. And if they are relevant, the court provides no basis for its characterization of this kind of controversy.

Well, so what? Why worry that the precedent happens to be built on sand? There are two responses. First, *NorCon* is the leading case in the leading commercial law jurisdiction. If the decision is fundamentally flawed, can future parties rely on its continued vitality? Second, and perhaps more important, *NorCon* provides a good illustration of a problem Judge Posner raised nearly a quarter century ago:

And especially in cases where there is no published dissent, judicial opinions exemplify “winners’ history.” The appellate court will usually state the facts as favorably to its conclusions as the record allows, and often more favorably. . . . The tendency I have described is abetted by the reluctance of academic commentators to expand their study of cases beyond judicial opinions. Rarely will the commentator get hold of the briefs and record to check the accuracy of the factual recitals in the opinion.<sup>9</sup>

In this instance the problem with the facts is more one of omission, rather than misstatement. The result is the same—an inaccurate picture and an unsupportable conclusion.

What does one do with such an unfounded precedent? In this instance, a rethinking of the doctrine is in order. If anything, the court got it backwards. The camel’s nose is coming under the wrong end of the tent. If the adequate assurance doctrine is to develop incrementally, the appropriate end of the contract spectrum is not complex, heavily negotiated contracts in which the issue of adequate assurance can be (and, arguably, has been) bargained over *ex ante*. Rather, if the doctrine is to be extended beyond the sale of goods, it should be for contracts in which the

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<sup>8</sup> “On consideration of the briefs, appendix, record, and the oral argument in this appeal, it is hereby ORDERED that the Clerk of this court transmit to the Clerk of the New York Court of Appeals a certificate in the form attached, together with a complete copy of the briefs, appendix and record filed by the parties with this court.” *NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp.* 110 F.3d 6, 32 UCC Rep.Serv.2d 833, C.A.2 (N.Y.), 1997 *certified question accepted*, 681 N.E.2d 1293 (N.Y. 1997) and *certified question answered*, 705 N.E.2d 656 (N.Y. 1998).

<sup>9</sup> Richard A. Posner, *The Problems of Jurisprudence* 210-211 (1990).

parties are not likely to have put much thought into the matter: “They-would-have-included-it-had-they-bothered-to-think-about-it” type of case. I am not arguing that the doctrine should be extended, only that this would have been a more appropriate incremental extension.

Now, the court only said that New York would recognize the adequate assurance doctrine in this type of transaction. It does not follow that a court, upon rehearing, would have required that NorCon provide such assurance. That would depend upon the facts. The case did eventually go to trial, but the parties settled before a decision was rendered. As we shall see (Section VI), NorCon did well in the settlement, but the uncertainty of the application of the law impacted the settlement negotiations. If the decision remains good law, the right to demand assurance, even if the demand were likely to fail, could be a valuable asset in renegotiation of a contract or bargaining over settlement terms.

The case itself was merely one skirmish in a bigger battle, the origins of which precede this particular agreement by over a decade. The story begins with federal legislation that was supposed to reduce American dependence on foreign oil. Public utility electric companies, like Niagara Mohawk, were required to buy power from non-utility generators (or NUGs), like NorCon.<sup>10</sup> The utilities entered into contracts with the NUGs, not because they wanted to, but because they had to. The shape of these agreements was determined in part by years of litigation and by proceedings in state public utility commissions. Niagara Mohawk, like many other utilities, had long-term agreements with a large number of NUGs in the early 1990’s—its general counsel claimed that there were more than 150 such contracts in 1996.<sup>11</sup> When changed circumstances made these contracts appear very bad from the utilities’ perspective, they responded by trying to get the contracts revised, terminated, or bought out. The demand for adequate assurance was only one of the strategies deployed.

The larger context is crucial to understanding why the contract took the form that it did. As will be described in Section I, the *NorCon* decision was only one of many involving disputes between public utilities and independent power producers operating under long-term contracts. The *NorCon* contract will be described in Section II. Section III presents the problem that triggered Niagara’s demand for assurance. The litigation will be summarized in Section IV. The parties’ awareness of the risks associated with contracts of this sort and the buyer’s need for some form of assurance will be considered in Section V. Niagara settled most of its disputes with the NUGs, including the *NorCon* dispute; the terms of the settlements will be presented in Section VI. Section VII concludes.

## **I. The Context**

Congress enacted the Public Utility Regulatory Policies Act (PURPA) in 1978.<sup>12</sup> The avowed purpose was to reduce dependence on foreign oil by encouraging the development of alternative power sources. Regulated electric power companies were required to purchase power

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<sup>10</sup> While PURPA was supposed to encourage the use of non-hydrocarbon sources, some of the NUG’s, including *NorCon*, were powered by natural gas.

<sup>11</sup> Paul J. Kaleta, Reassessment Of PURPA Power Purchase Agreements, And PURPA Itself, Is Imperative With The Advent Of Competitive Electric Markets, *Journal Of Project Finance*, Spring 1996, 6, 8.

<sup>12</sup> 16 U.S.C. §§ 824a-3.

in long-term Power Purchase Agreements (PPAs) from alternative power producers, like NorCon. PURPA directed the Federal Regulatory Energy Commission (FERC) to issue rules to be implemented by the states to buy electricity from alternative qualifying suppliers (QFs).<sup>13</sup> To encourage the QFs, much of the price risk was shifted from the QFs to utilities and ratepayers.<sup>14</sup> Prices were to be based on long run avoided costs (LRAC). The LRAC are costs that the utility would have to bear, but for the agreement with this supplier. Significantly, the LRAC could either be reckoned at the time of contracting or at the time of delivery.<sup>15</sup> That difference turns out to be crucial to understanding why the NorCon deal, and others, fell apart so quickly.

In one of the many pieces of litigation generated by this law, the Second Circuit Court of Appeals summarized what happened next in New York:

In 1980, the New York legislature enacted New York Public Service Law § 66-c, which provided that the PSC [Public Service Commission] would require state-regulated electric utilities to enter into agreements for the purchase of electricity from QFs. The PSC was charged with overseeing the contracting process, including approval of the contracts and setting power purchase rates. New York initially did not adopt PURPA's "avoided cost" ceiling for electricity purchases. In 1981, section 66-c was amended to require the PSC to establish a minimum sales price of at least six cents per kilowatt hour for power purchased from state qualifying QFs. This amendment is commonly referred to as the "Six-Cent Law." The New York legislature amended section 66-c again in 1992, partially repealing the Six-Cent Law. The 1992 amendment, however, preserved the six-cent minimum rate with respect to certain contracts executed and filed with the PSC on or before June 26, 1992.<sup>16</sup>

The six cent rate was above LRAC when implemented in the early 1980's. After years of litigation and regulatory hearings, FERC ruled that the states could no longer set a minimum price above LRAC. However, the ruling was only prospective so that earlier contracts were

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<sup>13</sup> To complete the alphabet soup, the QFs were also labeled non-utility generators (NUGs) or independent power producers (IPPs). There was not quite a 100% overlap between the three categories, but it is close enough so that I will use the terms interchangeably.

<sup>14</sup> Almost a decade after passage of the Act, FERC noted: "A major purpose of PURPA is to encourage cogeneration and small power production. The uncertainty of future revenues from purchases by utilities can make it difficult for the QF developer to obtain project financing. The principal reason for the existence of fixed-price contracts between utilities and QFs is to reduce this uncertainty by shifting risks from the QF to the purchasing utility or its ratepayers. The regulations implementing section 210 of PURPA recognize this and provide specific authority for utilities and QFs to enter into long-term, fixed-price contracts designed to give developers the financial security they need to make these projects viable." ¶ 32,457 Administrative Determination Of Full Avoided Costs, Sales Of Power To Qualifying Facilities, And Inter-Connection Facilities, March 16, 1988, Docket No. Rm88-6-000, 18 Cfr Part 292, 53 F.R. 9331, 55 F.R. 31882

<sup>15</sup> "Each qualifying facility shall have the option . . . to provide energy or capacity pursuant to a legally enforceable obligation for the delivery of energy or capacity over a specified term, in which case the rates for such purchases shall, at the option of the qualifying facility exercised prior to the beginning of the specified term, be based on either: (i) The avoided costs calculated at the time of delivery; or(ii) The avoided costs calculated at the time the obligation is incurred." 18 C.F.R. § 292.304.

<sup>16</sup> *Niagara Mohawk Power Corp. v. Federal Energy Regulatory Com'n* 306 F.3d 1264, 1266-7 C.A.2 (N.Y.),2002.

grandfathered.<sup>17</sup> Niagara Mohawk had eighteen long-term contracts with the six-cent rate. Seven were settled in the Master Restructuring Agreement (to be discussed below). The others it continued to litigate without success in suits against the PSC and FERC.<sup>18</sup> A second set of contracts were long-term, front-loaded contracts. In some the contract price was fixed for the life of the agreement (typically fifteen years) at a discount from the projected LRAC.<sup>19</sup> In others, which included the NorCon agreement, it was anticipated that the utility would overpay in the early years and make up the difference with a “tracking account” in the later years. Niagara Mohawk’s general counsel noted that most of these were “held by large gas-fired cogeneration projects and represent the most onerous IPP contracts in Niagara Mohawk’s generation mix.”<sup>20</sup>

The higher the expected prices paid to the QFs, the more encouragement there would be for alternative power sources. There is a potential tradeoff between encouraging the alternative sources and consumer prices, although courts and regulators initially denied it. The hoped for results from PURPA were oft-cited. For example: “As noted by PSC, if this project is successful, ratepayers will benefit in the future from cheaper electricity that will more than offset the above avoided-costs rates paid during the first half of the contract, in addition to having a new and innovative garbage-to-energy domestic power supply technology.”<sup>21</sup> The Supreme Court held early on that in promulgating its regulations FERC should err on the side of encouraging the non-traditional producers.<sup>22</sup> As time passed, the adverse impact on future electricity consumers became more likely and the future benefits from encouraging the non-petroleum sources became less likely; the PSC (and some regulators from other states), as we will see, came to put more weight on the high prices to be borne by the utility’s customers.

The system worked; indeed, it worked too well. Within a decade, Niagara Mohawk had been required to enter into contracts for IPP output greater than the power demand in its service territory. Years later it summarized the situation:

Since PURPA and the Six-Cent Law were passed, the Company was obligated to purchase electricity offered from IPPs in quantities in excess of its own demand and at prices in excess of those available to the Company by internal generation or for purchase in the wholesale market. In fact, by 1991, the Company was facing a potential obligation to purchase power from IPPs substantially in excess of its peak demand of 6,093 MW. As a result, the Company’s competitive position and financial performance deteriorated

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<sup>17</sup> *Orange & Rockland Utils., Inc. (“O & R I”)*, 43 F.E.R.C. ¶ 61,067, reh’g denied, 43 F.E.R.C. ¶ 61,546, 1988 WL 244978 (1988); and *Connecticut Light & Power Co.*, 70 F.E.R.C. ¶ 61,012, 1995 WL 9931 (1995).

<sup>18</sup> *Niagara*, 306 F.3d 1264; *Niagara Mohawk Power Corp. v. F.E.R.C.*, 162 F.Supp.2d 107 (N.D.N.Y. 2001); *New York State Elec. & Gas Corp. v. Saranac Power Partners L.P.*, 117 F.Supp.2d 211 (N.D.N.Y. 2000). For details of the extensive battles in courts and administrative agencies, see Rohit C. Sharma, *Niagara Mohawk Power Corp. v. FERC*, *Energy Law Journal* 23, 157 (2002).

<sup>19</sup> The contracts New York State Electric & Gas Corporation (NYSEG) had with two QFs, Saranac and Lockport, were both for fifteen years. In both instances, NYSEG had attempted to get a tracking mechanism incorporated into the contract but had been rebuffed by the PSC. *NYSEG*, 117 F.Supp.2d at 218.

<sup>20</sup> Kaleta *supra* note 12, at 6, 11

<sup>21</sup> *Matter of Niagara Mohawk Power Corp. v. Public Serv. Comm’n. of State of N.Y.*, 530 N.Y.S.2d 626, 629 (1988).

<sup>22</sup> *Am. Paper Inst., Inc. v. Am. Elec. Power Serv. Corp.*, 461 U.S. 402, 103 S.Ct. 1921, 76 L.Ed.2d 22 (1983).

and the price of electricity paid per KWh by its customers rose significantly above the national average. Accordingly, in 1991 the Company initiated a parallel strategy of negotiating individual PPA buyouts, cancellations and renegotiations, and of pursuing regulatory and legislative support and litigation to mitigate the Company's obligation under the PPAs. By mid-1996, this strategy resulted in reducing the Company's obligations to purchase power under its PPA portfolio to approximately 2,700 MW.<sup>23</sup>

When the regulated electric utilities' actual avoidable costs fell below the contract prices (the six cent rate or the projected avoidable costs), they scrambled to revise or terminate their obligations. The *NorCon* litigation was only one of many involving Niagara that ended up in court or regulatory commission proceedings.<sup>24</sup> Niagara was not the only New York utility enmeshed in such litigation.<sup>25</sup> Nor were the battles limited to New York utilities.<sup>26</sup> In some states the regulators were sympathetic to the utilities and their rate-payers, but their efforts to alter the contracts were opposed by the QFs, which argued successfully that modification was preempted by PURPA<sup>27</sup>

## II. The Contract

NorCon was a limited partnership with the sole purpose of building, owning, and operating this QF.<sup>28</sup> It was a special purpose entity with no other assets.<sup>29</sup> The lender's sole source of repayment would be the future stream of revenue. In April 1989, the NorCon-Niagara PPA was submitted to the PSC, which had to approve all contracts with QFs. The PSC rejected the initial agreement in part because the security was inadequate. An amended agreement dated January 3, 1991 was also rejected. After a second amendment the agreement was finalized July 22, 1991. NorCon would construct a power plant and Niagara would take all the output for 25 years. NorCon was financed by a fifteen-year, \$120 million loan from GE Capital. Construction was completed in late 1972 and on December 12, 1992 NorCon began delivering electricity to Niagara.

<sup>23</sup> Niagara Mohawk Power Corp. 1999 Annual Report [hereafter cited as 1999 Annual Report].

<sup>24</sup> The following is a partial listing of Niagara's IPP litigation: *Fulton Cogeneration Associates v. Niagara Mohawk Power Corp.*, 84 F.3d 91 (Cir. 2d. 1996); *O'Shanter Res., Inc. v. Niagara Mohawk Power Corp.*, 915 F. Supp. 560 (W.D.N.Y. 1996); *Stevens & Thompson Paper Co., Inc., v. Niagara Mohawk Power Corporation*, 750 N.Y.S.2d 335 (2002); *Sterling Powers Partners, L.P. v. Niagara Mohawk Power Corp.*, 657 N.Y.S.2d 604 (1997); *Sterling Powers Partners, L.P. v. Niagara Mohawk Power Corp.*, 657 N.Y.S.2d 407 (1997).

<sup>25</sup> See, e.g., *New York State Electric & Gas Corp. v. Saranac Power Partners, L.P.*, 267 F.3d 128 (2nd Cir. 2001); *In re New York State Electric & Gas Corp.* 2002 WL 1022642 (N.Y.D.P.S.); *Consolidated Edison Co. v. Public Service Comm'n*, 472 N.E.2d 981 (N.Y. 1984), appeal dismissed, 470 U.S. 1075 (1985); *Orange & Rockland Utils., Inc. ("O & R I")*, 43 F.E.R.C. ¶ 61,067, *reh'g denied*, 43 F.E.R.C. ¶ 61,546, 1988 WL 244978; *Kamine/Besicorp Allegany L.P. v. Rochester Gas & Electric Corp.*, 908 F.Supp. 1180 (W.D.N.Y. 1995).

<sup>26</sup> See, e.g., *Freehold Cogeneration Associates, L.P. v. Board of Regulatory Commissioners of State of New Jersey*, 44 F.3d 1178 (3rd Cir. 1995); *Independent Energy Producers Association, Inc. v. California Public Utilities Commission*, 36 F.3d 848 (9th Cir. 1994); *Smith Cogeneration Management, Inc. v. Corporation Commission*, 863 P.2d 1227 (Okla. 1993).

<sup>27</sup> *Freehold*, 44 F.3d at 1194. Similarly, in *Smith Cogeneration Management, Inc. v. Corporation Comm'n*, 863 P.2d 1227, 1229 (Okla.1993), the court rejected a provision that would allow reconsideration and modification by the Corporation Commission of avoided costs after the contract had been agreed upon.

<sup>28</sup> The general partner was Northern Consolidated Power, Inc.

<sup>29</sup> Transcript of Oral Argument at 391, *NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp.*, F.Supp. 57 (S.D.N.Y. 1996) (No. 94 Civ. 1530). These special purpose entities were often referred to as "PURPA machines."

The relevant terms of the agreement for our purposes are the pricing formula and the security arrangements. According to PURPA, the avoidable cost standard could either refer to prices when electricity was actually delivered or estimated LRAC at the time the contract was entered into. The NorCon-Niagara PPA combined the two. It incorporated the 1988 LRAC projections for fifteen years, which had been determined by the PSC. LRAC projections for both peak and off-peak sales for the life of the contract were included as an attachment to the contract. Table 1 gives a weighted average for the years 1996-2007. The pricing rule covered three periods. It is somewhat confusing because the agreement includes two adjustment accounts. The former divides the first period from the second; the latter accumulates in the second period and is supposed to be eliminated in the course of the third period.

In the first period, the price would be six cents per kwh. Since the projected LRAC was below six cents in the early years, the contract deliberately front-loaded the payments. After a few years the projected LRAC would exceed six cents. Because there were two LRAC schedules—peak and off-peak—and because the quantity would vary, the date at which the LRAC would exceed six cents would depend on the mix and interest rates. When the LRAC was less than six cents, the difference would go into a “cumulative avoided cost account.” When the LRAC exceeded six cents, that account would be reduced accordingly. When the account reached zero, the first period would be at an end.<sup>30</sup> The period was expected to last about four years.<sup>31</sup>

In the second period the price would be 95% of Niagara’s “tariff avoided cost,” subject to a ceiling and a floor, both based on the 1988 LRAC. The tariff avoided cost is the current avoided cost. So, if the projected LRAC proved to be accurate, this would be a five percent discount. If, however, the two diverge, the ceiling and floor might come into play, as, in fact, happened. The ceiling and floor were both based on the LRAC schedule. The ceiling was 110% and the floor 90%. If either were binding, the difference would go into an “adjustment account.” The second period ended fifteen years after the initial delivery of electricity. For the remaining ten years the price would be 90% of the tariff avoided cost, adjusted for any amount remaining in the adjustment account.<sup>32</sup> If things worked out, the back-end discounts would more than make up for the front-loaded payments.<sup>33</sup> This mechanism, adopted in many contracts between electric utilities and QFs is referred to as a “tracking mechanism” or a “true-up”. The details of the true-up are not important. Suffice it to say that if, as Niagara projected, NorCon ended up with a considerable surplus, the price it would be paid in the later years would be substantially reduced. Indeed, as we shall see, if Niagara’s projections were accurate, they would have resulted in a *negative price* in the last decade.

**Comment [N1]:** Originally, the cite was to page 8, but I didn't find any information on page 8. Instead, I found on page 5 language that indicates that operation would commence in 1992 and the second period would run from 1996 to 2007, which is only 4 years as opposed to the stated 5.

<sup>30</sup> Amounts in this account (and the adjustment account) would bear interest at 1.25 times the one-year Treasury bill rate. Clause 9(3). The PSC required that the rate in the first period be 11%. Case 28689-Request for Approval of an Energy Purchase Agreement Pursuant to Section 66-c of the Public Service Law: Niagara Mohawk Power Corporation and Northern Consolidated Power, Inc. – Contract No. 606, July 9, 1990. (hereafter Case 28689).

<sup>31</sup> Brief of Plaintiff-Appellee at 5, *Norcon*, 705 N.E.2d 656 (No. 10518).

<sup>32</sup> Prior to the amendment required by the PSC, the third period price was to be 95% of the avoided costs. Case 28689.

<sup>33</sup> If the LRAC projections were accurate, the PSC staff calculated that the present value of the stream of payments would amount to a 4.7 percent discount. It used an 11 percent discount rate and assumed that the short run avoided cost would equal the projected LRAC. Case 28689 at 11.

The litigation concerned Niagara's demand for assurance that NorCon would perform. The initial agreement did, in fact, provide for some security:

In order to secure the operation of the PLANT by the SELLER during the term of this AGREEMENT and to secure the balance of the Adjustment Account, SELLER hereby pledges a security interest in the amount of any positive balance in the Cumulative Avoided Cost Account, or the Adjustment Account, as the case may be, in the PLANT to NIAGARA. The lien created shall be upon all the works, plant, properties, and real and personal, constituting the PLANT in NIAGARA's favor.<sup>34</sup>

The PSC rejected the agreement, deeming this insufficient and asked for increased assurance. The first amendment to the agreement required that NorCon provide a letter of credit in the thirteenth year if at that time Niagara projected a positive balance at the end of the third period. (This mechanism was included in another litigated case, *Kamine/Besicorp Allegany L.P. v. Rochester Gas & Electric Corp.*)<sup>35</sup> However, the PSC rejected that as well. The second amendment eliminated that letter of credit and instead required that NorCon enter into a long-term fuel supply contract at fixed prices.<sup>36</sup> Since the largest component of LRAC is the cost of fuel, NorCon's fuel costs were expected to be closely correlated with the projected LRAC.<sup>37</sup> Of course, that only provided security if fuel prices rose more than had been anticipated. It did not provide security if, as actually happened, prices or other costs fell.<sup>38</sup>

It is important to bear in mind that Niagara did not want to enter into the contract. In its Brief, Niagara stated: "The contract at issue is not an ordinary contract that reflects the voluntary assumption of obligations and risks by contracting parties. Instead, Niagara Mohawk was required to enter into the contract with NorCon by . . . [PURPA and NY PSL §66-c]. The terms of the contract were dictated by the New York Public Service Commission."<sup>39</sup> The PSC chimed in. Although the PSC initially had approved the contract, by 1997 it had come to regret that decision. It could neither revise the contract nor order the parties to do so. It did, however, file an amicus brief on Niagara's side, stressing the non-voluntary nature of the agreement:

In traditional contract law, it is assumed that parties are able to negotiate reasonable agreements and, when necessary, protect themselves against non-performance through agreed-upon damages. This assumption loses force when parties are coerced into

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<sup>34</sup> Clause 9(5).

<sup>35</sup> 908 F.Supp. 1180 (W.D.N.Y.1995).

<sup>36</sup> Verified Complaint at ¶¶ 34-39, *NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp.*, 914 F.Supp. 57 (S.D.N.Y. 1996) (No. 94 Civ. 1530).

<sup>37</sup> In calculating LRAC for Niagara for 1992, the PSC found that about ¾ of the cost was for fuel. Opinion and Order Adopting Long-Run Avoided Costs, issued and effective June 26, 1992.

<sup>38</sup> In 1999, NorCon's counsel claimed that the contract price for gas was 72% above market and that NorCon had paid \$10 Million above market in 1998. Summary Judgment Hearing at 7, *Norcon*, 914 F.Supp. 57 (No. 94 Civ. 1530).

<sup>39</sup> Brief for Defendant-Appellant at 2, *NorCon*, 705 N.E.2d 656 (No. 10518). In its reply brief, Niagara emphasized the non-voluntary nature of its acquiescence: "The PSC required Niagara Mohawk to agree to front loaded pricing (i.e., pricing that resulted in overpayments during the initial years of the contract) and security terms that Niagara Mohawk deemed inadequate.... Niagara Mohawk brought an Article 78 challenge against one of the PSC's rulings, but without success.... Even though Niagara Mohawk did not thereafter challenge every additional contract that incorporated similar front loaded pricing and inadequate security terms, Niagara Mohawk's entry into these contracts was hardly voluntary." Reply Brief for Defendant-Appellant at 2-3, *Id.* (No. 10518).

agreements by, in this case, federal law. [This agreement] stands for the proposition that contracts of adhesion are an exception to the rule that “courts see no harm in express agreements limiting the damages to be recovered for breach of contract.” ... Here ... the contracts were imposed upon Niagara Mohawk.<sup>40</sup>

This is quite a remarkable statement. Despite the fact that it had monitored the negotiations, forced two amendments, and ultimately approved the agreement, the PSC labels this a “*contract of adhesion*.” It is not clear whether the PSC’s position represents a change of heart when the potential adverse effects on rate-payers became apparent, or whether it was the result of a change in administration.<sup>41</sup> Regardless, the not-quite-voluntary nature of the contract was apparent, a fact ignored by the court in its characterization of “this kind of controversy.”<sup>42</sup>

### III. The Problem

It became apparent almost immediately that the 1988 LRAC were much too high. If the discrepancy continued, the floor price would kick in and the adjustment account would grow rapidly. While the tracking mechanism would in principle equalize the payments over the life of the agreement, if the adjustment account were substantial the temptation for NorCon to simply walk away in the final ten years would be great.<sup>43</sup> Niagara (and other electric utilities) wanted out. Many strategies were deployed. So, for example, one utility’s complaint alleged “commercial impracticability/impossibility, mutual mistake, frustration of purpose, and anticipatory breach/prospective inability to perform. The action sought a declaration of the rights and obligations of the parties to the PPA, its rescission or, in the alternative, an Order directing the debtor to provide adequate assurances that it would perform the PPA.”<sup>44</sup>

As a result of this contract and others with IPPs, Niagara was overpaying for electricity. In its 1994 annual report it estimated that “it paid a premium of \$206 million in 1993 and expects to overpay by \$352 million in 1994 and \$421 million in 1995.”<sup>45</sup> To extricate itself, Niagara Mohawk utilized buyouts and demands for assurance. Early on, Niagara proposed buyouts: “In 1992 and 1993, Niagara Mohawk had contacted various other developers about the possibility of either delaying the start of construction or canceling projects. Niagara Mohawk makes no secret of the fact that it considers the above-market price terms the PSC imposes on contracts like the Agreement with O’Shanter to be economically unreasonable. As explained in the September 20, 1993 letter to O’Shanter, Niagara Mohawk’s buy-out policy was ‘to pay up to one and one half

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<sup>40</sup> Brief for PSC as Amicus Curiae Supporting Defendant-Appellant at 6, Id (No. 10518).

<sup>41</sup> In the interim, George Pataki had replaced Mario Cuomo as governor and John O’Mara had replaced Peter Bradford as chairman of the PSC.

<sup>42</sup> In the hearing on *NorCon*’s summary judgment after remand, Judge Sprizzo emphasized the non-voluntary nature of the contract: “It wasn’t as if they assumed this risk. The state said, you will do this. The state justification for saying, you will do this, was that we don’t think your downside is so great and you have the security under the second subordinated lien. Now it turns out the risk is much greater than the state assumed at the time that they forced the contract upon them, and there is a serious question as to whether the state would have forced the contract on them with knowledge of how large a risk this was going to be.” Summary Judgment Hearing at 16, *Norcon*, 914 F.Supp. 57 (No. 94 Civ. 1530).

<sup>43</sup> From the PSC’s perspective, the pricing would be inefficient—too high in the first fifteen years and too low in the last ten. If NorCon and others succeeded in walking away, the too low prices might not materialize at all.

<sup>44</sup> In re *Kamine/Besicorp Allegany, L.P.*, 214 B.R. 953, 958 (Bankr. D.N.J. 1997) (citing Malone Declaration, ¶ 11).

<sup>45</sup> See Niagara Mohawk Power Corp., 1994 Annual Report.

(1.5) times of actual project expenditures.”<sup>46</sup> As we shall see in Section VI, it did finally succeed in buying out many of the contracts, including NorCon’s. Additionally, Niagara sent letters demanding assurance of performance in the out-years to NorCon and eight other IPPs.<sup>47</sup> The extent to which the buy-out offers and demand letters overlapped is unclear.

The utilities also engaged in flyspecking the contracts. A nice example was Niagara’s negotiation with O’Shanter.<sup>48</sup> In the early negotiations, the buy-out price was in the \$2-3 million range. But in a ruling on another contract, the PSC held that the PPA was “site-specific.”<sup>49</sup> That is, if the contract was for a plant to be built at a specific site, and if the site of the plant changed after the contract had been approved, then the contract would no longer apply. Since the planned location of O’Shanter’s plant had been moved after the PSC had approved the agreement, the validity of the contract was now an issue. Niagara thereupon reduced its buy-out offer to \$50,000.<sup>50</sup>

The Niagara-NorCon contract established a floor and ceiling in the second period based on the 1988 LRAC. Within months of NorCon’s completing the plant and beginning production, the PSC produced a new schedule of LRAC, substantially below the 1988 numbers. Both schedules are shown in Table 1. A puzzle, which none of the briefs addressed is how Niagara (and the other electric utilities and the PSC) failed to anticipate the sharp decline in LRAC projections, given that the new projections were produced so close to the contract date. I will return to that question in Section V.

In October, 1992, before NorCon had delivered any power, Niagara filed a petition with the PSC asking that it require NorCon and other IPPs “to provide additional assurance to secure their future performance.”<sup>51</sup> Subsequently, Niagara asked that the PSC suspend action; the PSC refused and in June 1993 deemed the petition withdrawn. On February 4, 1994, two and a half years after the contract was signed and a little over a year after NorCon’s first delivery, Niagara sent NorCon a letter demanding that it provide assurance that it would meet its obligations in the third period.

Niagara Mohawk believes that due to changes in economic conditions since the agreement was entered, NorCon cannot and will not perform its repayment obligations in the later years of the Agreement. Niagara Mohawk, therefore, is demanding that within 30 days from receipt of this letter, NorCon provide adequate assurance to Niagara Mohawk that NorCon will duly perform all of its future repayment obligations, including the obligation to deliver electricity in the later years of the Agreement at prices less than Niagara Mohawk’s avoided costs and the obligations to repay in full any balance on the

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<sup>46</sup> O’Shanter Res., Inc. v. Niagara Mohawk Power Corp., 915 F. Supp. 560, 563 (W.D.N.Y. 1996) (citing D.Exh. 12).

<sup>47</sup> FORM 10-Q - For The Quarter Ended June 30, 1994.

<sup>48</sup> O’Shanter, 915 F.Supp at 563.

<sup>49</sup> Consolidated Edison Company of New York, Inc. and Indeck Energy Services of Yonkers, Inc., Case No. 89-E-1158 December 28, 1993,

<sup>50</sup> Ironically, in the course of their dispute O’Shanter demanded assurance that Niagara would perform and Niagara denied that it had to do so. O’Shanter, 915 F.Supp at 566.

<sup>51</sup> Brief for Plaintiff-Respondent at 10, NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E.2d 656 (N.Y. 1998) (No. 10518).

advance extended by Niagara Mohawk's customers which remains at the end of the Agreement's twenty-five year term.<sup>52</sup>

If NorCon failed to give such assurance within 30 days, Niagara claimed that it would treat the failure as a repudiation and it would have the right to terminate the agreement.

Niagara commissioned a study by an economic consulting firm to support its claim:

[B]ased on reasonable assumptions for NorCon's fuel costs and operating and maintenance expenses—determined by Niagara Mohawk's independent consultants [NERA] based on their many years of experience in the power production business—NorCon would have negative operating income ranging from approximately \$23.2 million to \$108.9 million in every year of the third period. Because it seems unlikely that NorCon would continue to operate the plant in the face of such substantial operating losses, but rather would more likely abandon the plant, Niagara Mohawk's customers appear unlikely to receive any repayment during the third period of the excess payment accrued in the Cumulative Avoided Cost Account during the second period. In effect, Niagara Mohawk's customers would be advancing over \$610 million to NorCon during the second period with no prospect of repayment.<sup>53</sup>

In its brief, Niagara restated the argument more forcefully:

Due to a dramatic drop in the price of electricity from other sources of supply, which the PSC did not foresee at the time that it dictated the terms of the contract, the estimated amount that NorCon will have to repay under the contract has skyrocketed from about \$21 million to over \$610 million, a nearly 30-fold increase. To repay the latter amount, NorCon would have to supply electricity for free and pay Niagara Mohawk between \$25 million and \$125 million each year during the last ten years of the contract.<sup>54</sup>

Moreover, it claimed, the value of the plant, the contractual security, would fall well short of the cumulative account. By the end of the second period (fifteen years) the shortfall was projected to be \$412 million.<sup>55</sup>

What could NorCon do that would satisfy Niagara? The letter provided a number of suggestions:

The adequate assurances of NorCon's future performance requested by this letter conceivably could take many forms. Without attempting to be exhaustive, Niagara Mohawk would be willing to accept any step that reasonably ensures the

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<sup>52</sup> Letter from Clement E. Nadeau to James R. Douglass Re: Northern Consolidated Power, Inc. Power Purchase Agreement (PPA) #606, February 4, 1994), p. 1 (hereinafter referred to as Demand Letter)

<sup>53</sup> Demand Letter at 6. In 1999 at the summary judgment hearing, Niagara's counsel claimed that the company was losing \$1 million per week. Demand Letter at 24.

<sup>54</sup> Brief for Defendant-Appellant at 2-3, *NorCon*, 705 N.E.2d 656 (No. 10518).

<sup>55</sup> Demand Letter at 7.

performance of NorCon's future repayment options, including the posting of a letter of credit or the creation of an escrow account to reserve the amounts necessary to meet the repayment obligations as they mature. Niagara Mohawk, however, invites any other proposal that assures performance of NorCon's repayment obligations in a commercially reasonable manner in light of the particular nature of the insecurity described above.<sup>56</sup>

NorCon disputed both the numbers and the notion that it should provide any assurance beyond that already in the contract. To determine the annual prices, the consultants simply plugged in the best current estimate of future prices, namely the 1993 projected LRAC. NorCon objected on the ground that there were large fluctuations in the components making up the LRAC and that projected LRAC did not necessarily correspond to actual prices.<sup>57</sup> It noted that the PSC's amicus brief, while supporting Niagara, used 1997 LRAC and concluded that the shortfall would be \$330 million, not \$610 million.<sup>58</sup> NorCon was certainly correct in arguing that the fifteen year projection of LRAC in 1993 would diverge from realized avoided costs in the same period, and, given the volatility of fuel prices, the deviation could be large.<sup>59</sup> It suggested that Niagara should have foreseen the price decline. With regard to the adequate assurance claim, NorCon made three points. First, it argued that the agreement already did take the assurance issue into account. Second, Niagara (and the PSC) knew the risks. Third, it would not have been able to provide such assurance and Niagara knew it. NorCon pointed out that increased assurance would be at the expense of its lender who relied on the cash flow. The lender would most likely refuse to allow a change.<sup>60</sup> Moreover, if the Niagara projections were at all plausible, no third party would be willing to guarantee NorCon's third period obligation.

#### IV. The Litigation

Shortly after receiving the Demand Letter, NorCon filed suit asking for a Declaratory Judgment that it need not provide additional assurance.<sup>61</sup> Niagara counterclaimed seeking a counter declaration that it had properly invoked a right to demand adequate assurance. A second

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<sup>56</sup> Id. at 8.

<sup>57</sup> At trial NorCon's witnesses claimed that they could not project gains or losses so far into the future:

THE COURT: The bottom line, I take it – I guess you have been tendered as an expert on rate projections – is that you cannot say with a reasonable degree of certitude as an expert that the moneys to be recouped that are in the third phase of this contract will or will not be sufficient to put the tracking balance in equilibrium or something close to equilibrium –

THE WITNESS: Yes.

However, NorCon's contemporaneous documents (reports to GE Capital in 1993-1996) included projections of a deficit in the tracking account ranging from \$670 to \$714 million. Transcript of Oral Argument at 75-59, Id (No. 94 Civ. 1530).

<sup>58</sup> Brief for Respondent at 31, *NorCon*, 705 N.E.2d 656 (No. 10518) (citing Brief for PSC as Amicus Curiae Supporting Appellant at 7, Id (No. 10518)).

<sup>59</sup> The pricing structure was premised on the assumption that although the variance might be large, there would not be any bias, so that the 1988 LRAC would represent the mean of the distribution.

<sup>60</sup> "As is common in the independent power production industry . . . NorCon financed the construction of its power plant under a project financing commitment. Niagara is fully aware that a project financed facility cannot provide additional security, in cash or other assets, after the plant has been financed." Verified Complaint at 30, *Norcon*, 914 F.Supp. 57 (No. 94 Civ. 1530).

<sup>61</sup> Verified Complaint at 1, Id (No. 94 Civ. 1530).

IPP, Encogen, which had entered into a similar three-period, 25-year contract also sued and the two cases were considered together.<sup>62</sup> Niagara sent Encogen a demand letter the same day that it sent NorCon's, claiming projected losses of \$330 million. The Encogen agreement also included a lien upon the plant as assurance. The court emphasized that the lien was Niagara's exclusive remedy—the contract language was stronger than in the NorCon agreement.<sup>63</sup> Niagara argued that the right to demand adequate assurance was implicit in the regulatory framework, but the court would have none of that:

Niagara Mohawk further contends that the right to demand adequate assurances is a corollary to the prohibition under New York regulatory law against electricity rates set by the PSC that “would result in a substantial overcharge to [the utility's] rate payers.” . . . Notwithstanding that comprehensive regulatory scheme, neither Congress nor the New York legislature created a right to demand adequate assurances where an otherwise approved rate might, in the distant future, prove economically disadvantageous to the utility purchaser.<sup>64</sup>

Holding that New York law does not provide for a right to demand adequate assurance, the court granted Encogen's motion to dismiss Niagara's counterclaim. The Court of Appeals certified the question to the New York Court of Appeals, which, as noted in the Introduction, gave an affirmative answer to a narrower question.

The court noted with approval some of the commentary favoring the recognition of the right to demand assurance and was “now persuaded that the policies underlying the UCC 2-609 counterpart should apply with similar cogency for the resolution of this kind of controversy.”<sup>65</sup> It continued with language that failed to distinguish this kind of controversy from any other: “A useful analogy can be drawn between the contract at issue and a contract for the sale of goods. If the contract here was in all respects the same, except that it was for the sale of oil or some other tangible commodity instead of the sale of electricity, the parties would unquestionably be governed by the demand for adequate assurance of performance factors in UCC 2-609.”<sup>66</sup> The court does not hint at what might distinguish electricity from other non-goods transactions. Nor, for that matter, does it distinguish between long-term electricity contracts and shorter term, or spot, electricity contracts. And, of course, it said nothing about whether the regulatory framework or contractual language dealing with assurance had any bearing on the right to demand assurance.

The Second Circuit then vacated the district court opinion and remanded for further proceedings consistent with the opinion. A bench trial was held in the summer of 1999, but on November 23, 1999, before a verdict was handed down, the case settled.<sup>67</sup> The terms of the

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<sup>62</sup> Encogen Four Partners, L.P. v. Niagara Mohawk Power Corp. 914 F.Supp. 57 (S.D.N.Y. 1996).

<sup>63</sup> “The Encogen Agreement provides that ‘Niagara's exclusive remedy for [Encogen's] failure to pay the balance of the Adjustment Account is to foreclose its lien upon the [Encogen] plant.’” Id. at 62 n.5.

<sup>64</sup> Id. at 62.

<sup>65</sup> Id.

<sup>66</sup> Id.

<sup>67</sup> Re Niagara Mohawk Power Corporation Case 95-E-1162 New York Public Service Commission June 30, 2000.

settlement will be presented in Section VI.

## V. The Contract Assigned the Risks

Had the contract worked as planned, there would have been a modest overpayment in the first few years (the six-cent rate exceeded the projected LRAC) which would have been made up in the later years so that the present value of the payment stream would have been about five per cent less than if Niagara Mohawk had paid current LRAC for the entire 25-year period. The fifteen-year loan would have been paid off by the revenue stream from the first two periods. Things do not always go as they are planned however, especially when the planning horizon is as long as 25 years and the underlying data are volatile. When, as happened, things did go awry, Niagara responded with its demand for assurance. NorCon's grounds for refusing to provide that assurance were (A) Niagara should have known that the 1988 LRACs were too high; (B) fuel prices were volatile and so, therefore, were Niagara's tariff rates; and (C) Niagara was keenly aware of the need for security and bargained for it. There was ample evidence in the materials available to the courts to support the last two propositions; although the first would appear to be obvious, it turns out to be problematic.

### A. *The 1988 LRACs Were Too High*

Shortly after the agreement was approved, the PSC issued new LRACs that were, as noted, about 50% below the 1988 LRACs which had been incorporated into the contract. NorCon emphasized Niagara's role in the determination of LRAC schedules in the past<sup>68</sup> and the new LRAC schedule.<sup>69</sup> "Niagara was aware at the time of the execution of the Second Amendment of the possibility that LRACs would be dropping significantly. Niagara was aware of this from, among other sources, its participation commencing in March 1991 in the LRAC adjustment proceeding, the PSC's suspension of the 1990 LRACs in 1991, the PSC's public support for the concept of non-utility generators bidding for projects, and the expected impact of such bidding."<sup>70</sup> In an affidavit, NorCon's counsel noted that "The PSC in its March 12, 1991 Order instituting the LRAC proceeding ... publicly stated that the "[present] LRACs may be substantially overstated". ... Mr. Coram [one of the Niagara executives involved in negotiating the contract] testified that this March 1991 Order gave him reason to believe the LRACs would be substantially reduced, and heightened his concern over the risk of non-performance in the later years of these contracts."<sup>71</sup> He also noted that Niagara made internal calculations of the effects of differences between the contractual LRACs and possible future Niagara avoided costs.

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<sup>68</sup> "Throughout the 1980's, Niagara Mohawk believed the LRACs to be overstated, and therefore advocated and actively lobbied the PSC to reduce LRACs. Niagara Mohawk participated in a number of LRAC proceedings prior to 1991 in which it argued that the LRACs should be reduced. Thus, the fact that the LRACs were reduced in 1992 could hardly have surprised Niagara Mohawk." Affidavit of Thomas J. Hall in Support of Plaintiff's Motion for Summary Judgment at 36, *Norcon*, 914 F.Supp. 57 (No. 94 Civ. 1530).

<sup>69</sup> At trial a Niagara Mohawk witness testified that the firm believed that the 1988 LRAC was too high in 1990, but "in the '90 time frame neither did we know that these things would go by half ... or that the forecast would be off by a factor of 2, however you want to state it." Transcript of Oral Argument at 497, *Id.* (No. 94 Civ. 1530).

<sup>70</sup> Verified Complaint at 23-24, *Id.* (No. 94 Civ. 1530).

<sup>71</sup> Affidavit of Thomas J. Hall in Support of Plaintiff's Motion for Summary Judgment at 39-40, *Id.* (No. 94 Civ. 1530).

NorCon did offer one possible explanation for the sharp reduction in the LRAC schedule: “The 1988 LRACs reflected the costs of new power plants that Niagara Mohawk would have to build over the next 20 years to meet demand. By 1992, NorCon and other cogenerators had contractually committed to build those power plants and supply that energy, so the costs of those plants were not reflected in the 1992 incremental cost study.”<sup>72</sup> That is, the capital costs of new construction would not be incorporated into the LRAC. Still, one would have thought that this possibility would have occurred to Niagara.

Given the timing, it would seem that Niagara failed to recognize an obvious problem. Anyone negotiating a deal in 1991 should have seen the LRAC decline coming. If Niagara were the only one to err, that would be a powerful argument. But Niagara was not alone. Other utilities were also stuck with contracts with 1988 LRACs. Despite the fact that such a large drop in the projected LRACs should have been anticipated by anyone paying attention, everyone seems to have missed it.

Eugene Meehan, who was Niagara’s economic expert, has suggested to me how this puzzle might be resolved. NorCon originally petitioned the PSC to order Niagara to sign a contract in December 1988. A contract based on 1988 LRACs which were still fresh at the time of signing was signed in April 1989. While that contract was not approved by the PSC until the 1991 amendments, the obligation from a regulatory perspective was incurred with the signing of the original contract and NorCon was entitled to the 1988 LRACs. The regulatory process would, therefore, have locked in the 1988 LRAC long before the amended agreement was executed. Hence when the contract was finally executed in 1991, Niagara knew what it was getting into, but was incapable of avoiding a terrible deal, as the original contract signed in 1989, would have locked in NorCon’s entitlement to the 1988 LRACs. That would resolve the puzzle, but it suggests another one: why did the parties fail to mention this in their briefs? NorCon’s omission is understandable—it wanted to emphasize Niagara’s awareness of the likelihood that LRACs would be reduced. Niagara’s silence is more problematic. Rather than arguing that it was aware that the LRACs were too high (and implicitly saying that it had accepted the risk) when it entered into the agreement, it might have felt more comfortable arguing that changed conditions had upset the initial deal.

### *B. Volatility*

The volatility of LRAC projections was well understood by industry participants before Niagara and NorCon began negotiating their agreement. In a 1988 report, FERC noted the problems with any long-term, fixed-price contract: “Efficiency problems are especially likely when a long-term contract attempts to predict future fuel prices. Relative fuel prices have been especially volatile in the last few years. The potential for rapid and significant change in relative fuel prices in the presence of fixed-price contracts suggests the possibility of problems in the electric utility industry similar to the take-or-pay problems that developed in the natural gas industry.”<sup>73</sup> It continued: “To avoid problems such as those associated with take-or-pay contracts in the natural gas industry, the Commission wishes to stress the danger of including

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<sup>72</sup> Brief for Respondent at 10, *Norcon*, 705 N.E.2d 656 (No. 10518).

<sup>73</sup> Administrative Determination Of Full Avoided Costs, Sales Of Power To Qualifying Facilities, And Inter-Connection Facilities, 53 Fed. Reg. 9331 at 23 (proposed Mar. 16, 1988) (to be codified at 18 C.F.R. pt. 86).

forecasted fuel costs in the fixed rate structure of long-term contracts.”<sup>74</sup> Ironically, fuel prices were not the cause of the decline in both the measured LRAC and the actual avoided costs of Niagara and other utilities; oil prices actually were higher in mid-1992 than they were in 1988.

FERC noted that fixed-price, front-loaded contracts presented a number of problems. Even if they worked properly there would be intergenerational equity problems. Today’s rate-payers would subsidize future payers. There would be short-term inefficiency because the utility would have to take power from the QF even if its costs exceeded the current LRAC. And, of course, if the contract price turned out to be substantially higher than the current LRAC, as in fact happened, rate-payers would be hurt and the utility’s viability might be threatened.<sup>75</sup> “The Commission believes that designers and evaluators of fixed-price contracts need to encourage contracts that strike a balance between increased QF security and lowered transactions costs on the one hand, and increased inequity to ratepayers and economic inefficiency on the other. Such a balance can be achieved by manipulating both the pricing mechanism and other, non-price features of the contract.”<sup>76</sup> Whether parties could produce a contract structure that achieved such a balance is problematic; the NorCon-Niagara agreement didn’t even try.

Niagara, and everyone in the business, was aware of the risks of significant price changes. The second period pricing established a fixed range of prices—the projected LRACs, plus or minus ten percent. Niagara’s risk if the floor were binding for a reasonable length of time was substantial.

### C. Security

Niagara’s concerns about the adequacy of its security pre-dated the NorCon contract. In a 1988 decision rejecting Niagara’s position in an earlier dispute, the court recognized Niagara’s concern about the risk of an IPP’s non-performance in a front-loaded contract, but it nonetheless upheld the PSC’s finding that the security was adequate:

The PSC’s authorization of front-loaded pricing contracts of the type employed here are not uncommon in the case of hydroelectric facilities. That PSC is keenly aware that front-loaded contracts subject the purchaser, ultimately ratepayers, to the peril that the facility may never be capable of producing electricity at rates less than or equal to avoided costs is apparent from the agreement PSC ordered petitioner to enter into, for it capped the extent of the advanced payment to an amount equal to the asset value of the Shawmut facility and also gave petitioner a security interest in the plant with the option of possessing and operating it until repayment was accomplished. *Petitioner’s dissatisfaction with the adequacy of its repayment security, though understandable*, does not, as Supreme Court observed, warrant a court substituting its

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<sup>74</sup> Id. at 26.

<sup>75</sup> In arguing for approval of the Master Restructuring Agreement (MRA), Niagara said: “Niagara Mohawk insists the MRA is prudent, that bankruptcy is the likely alternative, and that corporate insolvency would not serve the public interest.” Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Niagara Mohawk Power Corporation for Electric Street Lighting Service, 1998 WL 214902 (N.Y.P.S.C.) at 8.

<sup>76</sup> Administrative Determination Of Full Avoided Costs, Sales Of Power To Qualifying Facilities, And Inter-Connection Facilities, 53 Fed. Reg. 9331 at 23 (proposed Mar. 16, 1988) (to be codified at 18 C.F.R. pt. 86).

judgment for that of the agency, where, as here, it has not been shown that the manner in which PSC exercised its judgment was irrational.<sup>77</sup>

In 1988, prior to the NorCon-Niagara agreement, FERC explicitly recognized the problem: “One risk to ratepayers is that a QF may simply go out of business or otherwise abrogate the contract in the later years of a front-loaded contract. This would mean that the future benefits paid for in the early years would never materialize. To the extent that this is a real problem, it may be dealt with through contractual provisions, such as liens on the QF’s physical assets or through other legally enforceable sanctions for non-compliance.”<sup>78</sup>

FERC also noted that substantial problems had arisen with QF contracts:

Complaints of overpayments to QFs have been well publicized. For example, Houston Lighting and Power Co. estimates it will incur over \$500 million in overpayments over the next eight years ( *see*, Comments to the Commission’s Conference on PURPA, Docket No. RM87-12-000, filed by Houston Lighting & Power Co. at 9), Niagara Mohawk Power Co. claims that the New York Public Service Commission estimated the company will incur \$180 million in overpayments by 2000 ( *see*, Comments to the Commission’s Conference on PURPA, Docket No. RM87-12-000, filed by Niagara Mohawk Power Co. at 12), and Pacific Gas and Electric Co. claims it will incur \$857 million in overpayments *per year* by 1990 ( *see*, Comments to the Commission’s Conference on PURPA, Docket No. RM87-12-000, filed by Pacific Gas and Electric Co. at 26).<sup>79</sup>

In his affidavit, NorCon’s lawyer cited substantial deposition testimony by Niagara executives regarding their concerns about the adequacy of the security in this contract.<sup>80</sup> For example:

Q. Now, am I correct that Niagara Mohawk foresaw the possibility that the lien on the plant might not be sufficient to satisfy the balance of the tracking account at the end of the term of this contract?

A. Yes, we were convinced [of] it. [Niagara Mohawk] did sensitivity studies to determine what the exposure was in the event that there was deviations from [the] then current LRACS.<sup>81</sup>

What remains unclear is whether Niagara conveyed the inevitability of disaster, given the newer information, and whether the PSC took it into account.

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<sup>77</sup> Niagara Mohawk Power Corp. v. Public Service Comm’n of State of N.Y., 530 N.Y.S.2d 626, 629 (1988) (emphasis added).

<sup>78</sup> Administrative Determination Of Full Avoided Costs, Sales Of Power To Qualifying Facilities, And Inter-Connection Facilities, 53 Fed. Reg. 9331 at 24 (proposed Mar. 16, 1988) (to be codified at 18 C.F.R. pt. 86).

<sup>79</sup> *Id.* at 35.

<sup>80</sup> See Affidavit of Thomas J. Hall in Support of Plaintiff’s Motion for Summary Judgment at 17-22, *Norcon*, 914 F.Supp. 57 (No. 94 Civ. 1530).

<sup>81</sup> Affidavit of Thomas J. Hall in Support of Plaintiff’s Motion for Summary Judgment at 18, *Id.* (No. 94 Civ. 1530).

#### *D. In Sum*

So, by the time Niagara was negotiating the NorCon agreement, it and the rest of the industry were well aware of the need for security in the long-term QF contracts. It wanted greater security, fought for it, but was unable to convince the PSC that it should have it. When the contract turned out to be a disaster, Niagara sought the security it could not get in the initial bargain. The court gave it at least a fighting chance of succeeding. The PSC, reversing itself, now believed that the security was inadequate (true) and that the court should require the additional security (since the PSC could not legally do so). To be clear, if Niagara did actually have the right to demand assurance, NorCon could not have provided it. The result would have been the same as if the court had excused Niagara by, invoking impracticability, frustration, or mutual mistake.

#### **VI. Settlement**

In 1996, while the *NorCon* case was still pending, Niagara initiated negotiations to terminate, restate, or amend a substantial portion of its above-market PPAs, including NorCon's. The negotiations culminated in a Master Restructuring Agreement (MRA); the initial version was for 16 IPPs, but NorCon and one other opted out. NorCon did, however, agree to continue negotiating in good faith.<sup>82</sup> Niagara paid a substantial price in cash and stock; the agreement reduced annual IPP payments by about \$500 million. Niagara summarized the essential features of the deal:

The MRA was consummated on June 30, 1998 with 14 IPPs. The MRA allowed the Company to terminate, restate or amend 27 PPAs which represented approximately three-quarters of the Company's over-market purchase obligations. The Company terminated 18 PPAs for 1,092 MW of electric generating capacity, restated eight PPAs representing 535 MW of capacity and amended one PPA representing 42 MW of capacity. Niagara Mohawk paid the IPP Parties an aggregate of \$3.934 billion in cash, of which \$3.212 billion was obtained through a public market offering of senior unsecured debt, \$303.7 million from the public sale of 22.4 million shares of common stock, and the remainder from cash on hand. In addition, Niagara Mohawk issued 20.5 million shares of common stock to the IPP Parties.<sup>83</sup>

The NorCon dispute was remanded, and a bench trial was held in summer 1999. At trial Niagara's expert testified that the tracking account stood at \$107 million in 1998 and he projected that it would grow to \$835 million by 2007; the contract rate in year 16, he said, would

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<sup>82</sup> "The Company and NorCon shall conduct separate good faith negotiations to enter into an agreement (the "NorCon Agreement") regarding the amendment, amendment and restatement, other restructuring or termination of NorCon's Existing PPA. The Company and NorCon agree to commence such negotiations, at a mutually agreeable location(s), promptly following the date of this Agreement and to meet not less frequently than weekly during the first month following the date of this Agreement and thereafter as the Company and NorCon may mutually agree. . . . In the event the Company and NorCon are unable to agree in writing on the additional consideration, if any, to be received by NorCon within seventy-five (75) days after the date of this Agreement (which date may be extended with the mutual agreement of the Company and NorCon), then (i) this Agreement shall terminate with respect to NorCon." MRA at 2.5.

<sup>83</sup> Niagara Mohawk Holdings, Annual Report (Form 10-K), at (March 17, 2000).

be negative \$90 per megawatt hour.<sup>84</sup> That is, NorCon would have defaulted and surrendered its plant to Niagara.

Judge Sprizzo professed to being unclear as to his mandate; he urged the parties to settle:

It is really a question of how we fit the law to this set of facts. We are in uncharted territory. The first time around, I thought the law was clearer. I dismissed the action on the theory they were not entitled as a matter of law to reasonable assurances. Now the Court of Appeals says that maybe they are entitled to assurances as a matter of fact. Then you are in the realm of what I call equitable discretion and how much I have. That has to be briefed for me at the end of the case. The Court of Appeals will be operating on an abuse-of-discretion standard.

I don't practice law any more – although, in a sense, I guess I do – but it is big dice to roll on the exercise of any judge's discretion. I don't care who the judge is – I say that with all humility, having sat on the bench for almost eighteen years – we don't always get it right. And sometimes, when we get it right, we get reversed, and sometimes, when we get it wrong, we get affirmed. It is a big risk to take.

I think, if you have some money out there in the family tree, so to speak, as apparently you do, then maybe settlement should get on the table here, and maybe they will take something less than 100 cents on the dollar by way of assurances with respect to the contract.<sup>85</sup>

Before a verdict was rendered, on November 23, 1999, the parties did indeed settle. The PPA would be terminated and NorCon would receive \$125 million. And so, five years after Niagara sent its demand letter, the dispute was resolved. Whether the court's answer to the certified question impacted the settlement, we cannot be certain, although the judge's comments do suggest that it did. Still, since NorCon would have had to default if Niagara's right to demand assurance was upheld, the \$125 million payment is pretty good evidence that the effect on settlement was modest at best.

## VII. Conclusion

Sometimes judges talk too much. Had they simply invoked the Restatement, there would have been no basis for criticizing the decision. But they didn't. Instead, they took a more nuanced approach, invoking “our customary incremental common-law developmental process, rooted in particular fact patterns and keener wisdom acquired through observations of empirical application of a proportioned, less than absolute, rule in future cases.”<sup>86</sup> Missing from the opinion, however, are the “particular fact patterns” and “observations of empirical application.” Had it practiced what it appeared to preach, the court could have disposed of this case by recognizing that the contract had been imposed on Niagara Mohawk as a matter of public policy

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<sup>84</sup> Transcript of Oral Argument at 620-622, *NorCon*, 914 F.Supp. 57 (No. 94 Civ. 1530).

<sup>85</sup> Transcript of Oral Argument at 329-330, *NorCon*, 914 F.Supp. 57 (No. 94 Civ. 1530).

<sup>86</sup> *NorCon*, 705 N.E.2d at 661.

(however misguided that turned out to be) and had gone through a regulatory process that dealt explicitly with the assurance issues. The risks of a fixed-price, front-loaded 25-year agreement were obvious. The parties knew what they were and attempted to provide for them in the contract. Assurance was not an afterthought; Niagara had been concerned about assurance questions in this type of contract for a decade. For whatever reasons Niagara could not, at contract formation, convince the PSC to give it more security.

The New York court clearly liked the idea of recognizing a common law right to demand assurance. If it had wanted to do so while still following its incremental process, it could have stressed the conditions in which it *would not recognize* the right. It could have said that while it was sympathetic in general to the notion that an insecure party should be able to demand assurance, the facts precluded it from doing so “in this kind of controversy,” one in which the assurance question had been thoroughly vetted. For reasons unstated, it chose not to do so. This is not to say that the court’s bottom line was necessarily wrong—only that you can’t get there from here.

One rationalization proffered by the court for its position was that it might encourage settlement of disputes. “The availability of the doctrine may even provide an incentive and tool for parties to resolve their own differences, perhaps without the necessity of judicial intervention. Open, serious renegotiation of dramatic developments and changes in unusual contractual expectations and qualifying circumstances would occur because of and with an eye to the doctrine’s application.”<sup>87</sup> The court did not bother to note that Niagara Mohawk had already settled a large number of similar claims without the court’s recognition of the right to demand assurance. Nor did it suggest why an open-ended standard which left the trial court judge befuddled would be a superior backdrop for renegotiation than a rule that did not recognize a right to demand assurance.

By the time the demand letter was sent it had become apparent that, barring something extraordinary (like \$140 a barrel oil), NorCon would not perform in the third period. But, so what? That simply meant that the parties had thirteen years to negotiate a buyout. That the FERC/PSC policies almost bankrupted Niagara is unfortunate, but that does not justify courts tweaking contract law to bail it out.

Niagara did not formally argue that its performance should be excused because of changed conditions or mistake. But, in effect, that would have been the result had the court affirmed its right to demand assurance. NorCon and the other QFs could not have provided acceptable assurance, so Niagara could have walked away from the deals on thirty-day notice. At least one other New York judge rejected this ploy:

Furthermore, to suggest as NYSEG does, without apparently any sense of irony, that the parties were “mutually mistaken” about the risk that PPA rates would exceed avoided costs is paradoxical in light of the extensive attention paid to the need for a “true-up” or tracking mechanism in the contracts. Indeed, this risk was identified, discussed and reconciled by every party or entity even remotely affected by PURPA, including Congress in enacting the statute, FERC in prescribing the regulatory

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<sup>87</sup> *NorCon*, 705 N.E.2d at 662.

scheme, PSC in implementing it, utilities in forecasting LRACs, and QFs in making investment and other decisions.<sup>88</sup>

If the *NorCon* decision had come from some other jurisdiction, it might be of little import. But New York is different. It is the preeminent jurisdiction for commercial cases. It is generally considered to be a “hard law” or formalist jurisdiction. The case has had some precedential affect and the results are hardly encouraging. New York state and other state courts have essentially ignored the court’s “incremental” approach, extending the adequate assurances doctrine only to “this kind of controversy.” Instead, the courts have interpreted the *NorCon* decision to extend the adequate assurances doctrine to all contracts that are similar to the sale of goods.<sup>89</sup> In one case that did try to figure out just what the *NorCon* court meant by “this kind of controversy;” the court specifically pointed out that the doctrine of adequate assurances has only been extended to long-term contracts where a change in circumstances and security provision was not negotiated ex ante.<sup>90</sup> That court did not, of course, know that *NorCon* would have failed to qualify.

**Table 1. Niagara Mohawk LRACs 1988 and 1993**

<b>Year</b>	<b>1988</b>	<b>1993</b>
1996	80.58	28.70
1997	84.13	30.90
1998	87.73	32.40
1999	91.63	36.70
2000	95.63	41.30
2001	99.73	46.20
2002	104.14	51.00
2003	108.73	56.10
2004	113.43	61.60
2005	118.43	67.30
2006	123.63	72.00
2007	129.04	79.00

Source: Attachment to Demand Letter.

<sup>88</sup> New York State Elec. & Gas Corp. v. Saranac Power Partners L.P. 117 F.Supp.2d 211, 255 (N.D.N.Y. 2000).

<sup>89</sup> See e.g., McNeal v. Lebel, 157 N.H. 458 (2008) (holding that the trial court was correct to extend the adequate assurances doctrine to a contract for the construction of a modular home); In re Broadstripe, LLC, 435 B.R. 245 (Bankr. D. Del. 2010) (finding that the sale of cable and internet assets to be close enough to the sale of goods to extend the adequate assurances doctrine); In re Pacific Gas and Electric Co., 271 B.R. 626 (N.D.Cal. 2002) (holding the sale of electricity to be sufficiently like the sale of goods to be allowed the use of adequate assurances); Peng v. Willets Point Asphalt Corp., 910 N.Y.S.2d 407 (2010) (extending the doctrine of adequate assurances to real estate cases); Merrill Lynch Intern. V. XL Capital Assur. Inc., 564 F.Supp.2d 298 (S.D.N.Y. 2008) (finding adequate assurances cannot be extended to contracts for CDO swaps because they are not sufficiently like the sale of goods).

<sup>90</sup> River Terrace Associates, LLC v. Bank of New York, No. 603745/2002, 2005 WL 3134228, at \*7 (N.Y. Sup. 2005).

