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A Precedent Built on Sand: *Norcon v. Niagra Mohawk*

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A PRECEDENT BUILT ON SAND: *NORCON V. NIAGARA MOHAWK*[†]

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Under the common law, a contracting party could only demand assurance of performance if the other party was insolvent. If a party had reasonable grounds for insecurity, the UCC Section 2-609 allowed it to demand adequate assurance even if the counterparty were solvent. The Restatement (Second) adopted the same rule for non-goods. In NorCon v. Niagara Mohawk *the New York court extended the adequate assurance doctrine for some non-goods contracts. Although the decision seems to imply that there is some relation between the* NorCon *facts and its conclusion as to the law, there is none. Relying primarily on material available to the court, this paper examines the contract, the context in which it was written, and the events precipitating Niagara Mohawk's insecurity. While Niagara Mohawk's insecurity was no doubt justified—NorCon would almost certainly have walked away from its obligation for the last ten years of the contract—the assurance question had been a major issue in negotiating this contract, and in similar contracts involving Niagara Mohawk and other public utilities.*

[†] Conflict of interest statement: The expert witness for Niagara Mohawk in this case was Eugene Meehan of National Economic Research Associates ("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, Mr. Meehan provided me with some information from his files and with some insights regarding the contract and the regulatory context.

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I. INTRODUCTION

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. Or 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 acknowledging its unwillingness to perform (an anticipatory repudiation), B was faced with this awkward choice.

The UCC Section 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.[1]

The issue arose in a federal case applying New York law—*NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp.*[2] 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.?[3]

The Court of Appeals 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 merits of that position, the court chose a more nuanced position. It narrowed the question, making much of

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1 RESTATEMENT (SECOND) OF CONTRACTS § 251 (2010).

2 NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 110 F.3d 6, 7 (2d Cir. 1997).

3 *Id.* at 9.

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.[4]

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 do not 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 Section 2-609 counterpart should apply with similar cogency for the resolution of *this kind of controversy*."[5] 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

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[4] NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E.2d 656, 661–62 (N.Y. 1998) (citation omitted).

[5] *Id.* at 662 (emphasis added).

susceptible of all security features being anticipated, bargained for and incorporated in the original contract."[6]

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.[7] Perhaps Sprizzo mischaracterized the assurance embodied in the contract. Wrong. Indeed, if anything, he understated the contractual assurance afforded Niagara Mohawk.

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.[8]

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6 *NorCon*, 705 N.E.2d at 662.

7 Encogen Four Partners, L.P. v. Niagara Mohawk Power Corp., 914 F. Supp. 57, 59 (S.D.N.Y. 1996) ("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."), *vacated sub nom.* NorCon Power Partners v. Niagara Mohawk Power Corp., 163 F.3d 153 (2d Cir. 1998). Encogen and NorCon were similarly situated non-utility generators ("NUGs"). The initial suit was in Encogen's name. The appeal and subsequent litigation concerned NorCon.

8 The *NorCon* court issued the following order:

> 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

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 did not. 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 importantly, *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

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> 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, 7 (2d Cir. 1997). *Compare id., certifying question, with* NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E.2d 656 (N.Y. 1998), *certified question answered.*

> check the accuracy of the factual recitals in the opinion.[9]

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 parties are not likely to have put much thought into the matter: a "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 in Part VII, 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

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9 RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 210–11 (1990).

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.[10] 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.[11] 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 Part II, 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 Part III. Part IV presents the problem that triggered Niagara's demand for assurance. The litigation will be summarized in Part V. 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 Part VI. Niagara settled most of its disputes with the NUGs, including the NorCon dispute; the terms of the settlements will be presented in Part VII. Part VIII concludes.

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10 While the legislation was supposed to encourage the use of non-hydrocarbon sources, some of the NUGs, including NorCon, were powered by natural gas.

11 Paul J. Kaleta, *Reassessment of PURPA Power Purchase Agreements, and PURPA Itself, Is Imperative with the Advent of Competitive Electric Markets*, J. STRUCTURED FIN., Spring 1996, at 6, 8.

II. THE CONTEXT

Congress enacted the Public Utility Regulatory Policies Act ("PURPA") in 1978.[12] 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 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").[13] To encourage the QFs, much of the price risk was shifted from the QFs to utilities and ratepayers.[14] Prices were to be based on long-run avoided costs ("LRAC"). The LRAC is the cost that the utility would have to bear, but for the agreement with this supplier. Significantly, the LRAC could either be reckoned at the time

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12 Public Utility Regulatory Policies Act ("PURPA"), 16 U.S.C. §§ 2601–45 (2011).

13 To complete the alphabet soup, the QFs were also labeled NUG or independent power producers ("IPPs"). There was not quite a 100% overlap between the three categories, but it is close enough that I will use the terms interchangeably.

14 Almost a decade after passage of the Act, the 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.

Administrative Determination of Full Avoided Costs, Sales of Power to Qualifying Facilities, and Inter-Connection Facilities, FERC Docket No. RM88-6-000, FERC (CCH) ¶ 32,457 (proposed Mar. 16, 1988) (to be codified at 18 C.F.R. § 292) [hereinafter FERC Admin. Determination].

of contracting or at the time of delivery.[15] 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 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 . . . .[16]

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15 Section 292.304(d) requires:

> Each qualifying facility shall have the option . . . (2) 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(d) (2013).

16 Niagara Mohawk Power Corp. v. Fed. Energy Regulatory Comm'n, 306 F.3d 1264, 1266–67 (2d Cir. 2002).

The six-cent rate was above the LRAC when implemented in the early 1980's. After years of litigation and regulatory hearings, the FERC ruled that the states could no longer set a minimum price above the LRAC. However, the ruling was only prospective, grandfathering in the earlier contracts.[17] 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.[18] A second set of contracts was 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.[19] 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 [Independent Power Producer] contracts in Niagara Mohawk's generation mix."[20]

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 often cited. For example: "As noted by PSC, if

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17 Orange & Rockland Utils., Inc., 43 FERC ¶ 61,067, 61,185 (1988); Conn. Light & Power Co., 70 FERC ¶ 61,012 (1995).

18 *Niagara Mohawk*, 306 F.3d 1264; Niagara Mohawk Power Corp. v. FERC. 162 F. Supp. 2d 107 (N.D.N.Y. 2001); N.Y. 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, 23 ENERGY L.J. 57 (2002).

19 The contracts N.Y. State Elec. & Gas Corp. ("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. *See N.Y. State Elec. & Gas Corp.*, 117 F. Supp. 2d at 218.

20 Kaleta, *supra* note 11, at 11.

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."[21] The Supreme Court held early on that in promulgating its regulations, the FERC should err on the side of encouraging the non-traditional producers.[22] 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), 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 [megawatt]. As a result, the Company's competitive position and financial performance deteriorated and the price of electricity paid per KWh [kilowatt-hour] 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

21 Niagara Mohawk Power Corp. v. Pub. Serv. Comm'n, 530 N.Y.S.2d 626, 629 (App. Div. 1988).

22 Am. Paper Inst., Inc. v. Am. Elec. Power Serv. Corp., 461 U.S. 402 (1983).

> reducing the Company's obligations to purchase power under its PPA portfolio to approximately 2,700 MW.[23]

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 proceedings involving Niagara that ended up in court or regulatory commission proceedings.[24] But, Niagara was not the only New York utility enmeshed in such litigation.[25] Nor were the battles limited to just New York utilities.[26] Regulators in some states were sympathetic to the utilities and their rate-payers, but their efforts to alter the contracts were opposed by the QFs, which successfully argued that modification was preempted by PURPA.[27]

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23 Niagara Mohawk Power Corp., Annual Report (Form 10-K) (Mar. 24, 2000) [hereinafter 1999 Annual Report], *available at* http://www.sec.gov/Archives/edgar/data/71932/0001079182-00-000034.txt.

24 The following is a partial listing of Niagara's IPP litigation: Fulton Cogeneration Assocs. v. Niagara Mohawk Power Corp., 84 F.3d 91 (2d Cir. 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 Corp., 750 N.Y.S.2d 335 (App. Div. 2002); Sterling Powers Partners, L.P. v. Niagara Mohawk Power Corp., 657 N.Y.S.2d 604 (App. Div. 1997); Sterling Powers Partners, L.P. v. Niagara Mohawk Power Corp., 657 N.Y.S.2d 407 (App. Div. 1997).

25 *See, e.g.*, N.Y. State Elec. & Gas Corp. v. Saranac Power Partners, L.P., 267 F.3d 128 (2d Cir. 2001); N.Y. State Elec. & Gas Corp., Case Nos. 96-E-0131, 95-E-1162, (N.Y. Dep't Pub. Serv. Feb. 5, 2002), 2002 WL 1022642; Consol. Edison Co. v. Pub. Serv. Comm'n, 472 N.E.2d 981 (N.Y. 1984), *appeal dismissed*, 105 S. Ct. 1831 (1985); Orange & Rockland Utils., Inc., 43 FERC ¶ 61,067 (1998), *reh'g denied*, 43 FERC ¶ 61,546 (1988); Kamine/Besicorp Allegany L.P. v. Rochester Gas & Elec. Corp., 908 F. Supp. 1180 (W.D.N.Y. 1995).

26 *See, e.g.*, Freehold Cogeneration Assocs., L.P. v. Bd. of Regulatory Comm'rs, 44 F.3d 1178 (3d Cir. 1995); Indep. Energy Producers Ass'n, Inc. v. Cal. Pub. Utils. Comm'n., 36 F.3d 848 (9th Cir. 1994); Smith Cogeneration Mgmt., Inc. v. Corp. Comm'n, 863 P.2d 1227 (Okla. 1993).

27 *Freehold*, 44 F.3d at 1194. Similarly, in *Smith*, the court rejected a provision that would have allowed reconsideration and modification by the Corporation Commission of avoided costs after the contract had been agreed upon. *Smith*, 863 P.2d at 1229.

III. THE CONTRACT

NorCon was a limited partnership with the sole purpose of building, owning, and operating this QF.[28] It was a special purpose entity with no other assets.[29] 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 on July 22, 1991. NorCon would construct a power plant and Niagara would take all the output for twenty-five years. NorCon was financed by a fifteen-year, $120 million loan from GE Capital. Construction was completed in late 1992, and on December 12, 1992, NorCon began delivering electricity to Niagara.

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

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28 The general partner was Northern Consolidated Power, Inc.

29 Transcript of Record at 391, NorCon Power Partners, L.P. v. Niagara Mohawk Corp., No. 94 Civ. 1530 (S.D.N.Y. June 24, 1999) [hereinafter Transcript of Record] (on file with the Columbia Business Law Review). These special purpose entities were often referred to as "PURPA machines."

accumulates in the second period and is supposed to be eliminated in the course of the third period.

TABLE 1. NIAGARA MOHAWK LRACS 1988 AND 1993[30]

Year	1988	1993
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

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 the interest rate. 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.[31] The period was expected to last about four years.[32]

[30] Letter from Clement E. Nadeau, Vice President, Power Transactions & Planning, Niagara Mohawk Power Corp., to James R. Douglass, President, Northern Consolidated Power, Inc. app. at 1–3 (Feb. 4, 1994) [hereinafter Demand Letter] (on file with the Columbia Business Law Review).

[31] Amounts in this account (and the adjustment account) would bear interest at 1.25 times the one-year Treasury bill rate. Agreement between

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 5% discount. If, however, the two diverged, 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% of the schedule 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.[33] If things worked out, the back-end discounts would more than make up for the front-loaded payments.[34] 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

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Northern Consol. Power, Inc. and Niagara Mohawk Power Corp. 15 (Apr. 28, 1989) [hereinafter Norcon-Niagara Agreement] (on file with the Columbia Business Law Review). The PSC required that the rate in the first period be 11%. Niagara Mohawk Power Corp. Energy Purchase Agreement, Case No. 91-E-0121 (N.Y. Dep't Pub. Serv. Jan 25, 1991) (request for approval) [hereinafter EPA Approval Request] (on file with author).

32 Brief of Plaintiff-Appellee at 5, NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E. 2d 656 (N.Y. 1998) (No. 10518) (on file with Columbia Business Law Review).

33 Prior to the amendment required by the PSC, the third period price was to be 95% of the avoided costs. *See* EPA Approval Request, *supra* note 31.

34 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% discount. It used an 11% discount rate and assumed that the short run avoided cost would equal the projected LRAC. *See* EPA Approval Request, *supra* note 31, at 11.

Niagara's projections were accurate, they would have resulted in a *negative price* in the last decade.

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.[35]

The PSC rejected the agreement as 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 v. Rochester Gas & Electric*).[36] 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.[37] Since the largest component of the LRAC is the cost of fuel, NorCon's fuel costs were expected to be closely correlated with the projected LRAC.[38] Of course,

35 NorCon-Niagara Agreement, *supra* note 31, at 18.

36 Kamine/Besicorp Allegany L.P. v. Rochester Gas & Elec. Corp., 908 F. Supp. 1180, 1185 (W.D.N.Y. 1995).

37 Verified Complaint ¶¶ 34–39, Encogen Four Partners, L.P. v. Niagara Mohawk Power Corp., 914 F. Supp. 57 (S.D.N.Y. 1996) (No. 94 Civ. 1530) [hereinafter Verified Complaint] (on file with the Columbia Business Law Review) *vacated sub nom.* NorCon Power Partners v. Niagara Mohawk Power Corp., 163 F.3d 153 (2d Cir. 1998).

38 In calculating the LRAC for Niagara for 1992, the PSC found that about three quarters of the cost was for fuel. Order Adopting Long-Run Avoided Cost Estimates, Case No. 91-E-0237 (N.Y. Dep't Pub. Serv. June 26, 1992).

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.[39]

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 New York Public Service Law Section 66-c]. The terms of the contract were dictated by the New York Public Service Commission . . . .[40]

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

39 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. Transcript of Oral Argument at 7, Norcon Power Partners, L.P. v. Niagara Mohawk Power Corp., No. 94 Civ. 1530 (S.D.N.Y May 21, 1999) [hereinafter Summary Judgment Hearing] (on file with the author).

40 Brief of Defendant-Appellant at 2, NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E.2d 656 (N.Y. 1998) (No. 10518) (on file with the Columbia Business Law Review). 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 of Appellant at 2–3, *NorCon* 705 N.E.2d 656 (No. 10518) (citations omitted) (on file with the Columbia Business Law Review).

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 agreements by, in this case, federal law. [This is authority] 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.[41]

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.[42] 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."[43]

41 Brief for PSC as Amici Curiae Supporting Defendant-Appellant at 6, *NorCon* 704 N.E.2d 656 (No. 10518) (citations and internal quotation marks omitted) (citing Metropolitan Life Ins. Co. v. Noble Lowndes Int'l, Inc., 84 N.Y.2d 430, 436 (1994) (citing 5 CORBIN, CONTRACTS § 1068) (on file with the Columbia Business Law Review).

42 In the interim, George Pataki had replaced Mario Cuomo as governor, and John O'Mara had replaced Peter Bradford as chairman of the PSC.

43 In the hearing on NorCon's motion for 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

IV. THE PROBLEM

It became apparent almost immediately that the 1988 LRACs were much too high. In 1993, updated LRACs were produced, incorporating current information about prices. Table 1 shows that they were about half the 1988 figures (see Table 1). 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.[44] Niagara (and other electric utilities) wanted out, and as a result, deployed many strategies. For example, one utility's complaint alleged

> [C]ommercial 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.[45]

As a result of this contract and others with IPPs, Niagara was overpaying for electricity. In its 1994 annual report, Niagara estimated that "it made excess payments of approximately $205 million in 1993 and approximately $364 million in 1994 and expects to make excess payments of

> 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, *supra* note 39, at 16.

44 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.

45 *In re* Kamine/Besicorp Allegany, L.P., 214 B.R. 953, 958 (Bankr. D.N.J. 1997) (citations omitted).

approximately $409 million in 1995."[46] To extricate itself, Niagara 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 (1.5) times of actual project expenditures."[47]

As we shall see in Part VI, Niagara Mohawk 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.[48] The extent to which the buy-out offers and demand letters overlapped is unclear.

The utilities also engaged in flyspecking the contracts. An example of this was Niagara's negotiation with O'Shanter.[49] 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."[50] 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.

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46 Niagara Mohawk Power Corp., Annual Report (Form 10-K) (Mar. 29, 1995), available at http://www.sec.gov/Archives/edgar/data/71932/0000071932-95-000034.txt.

47 O'Shanter Res., Inc. v. Niagara Mohawk Power Corp., 915 F. Supp. 560, 563 (W.D.N.Y. 1996) (citations omitted).

48 Niagara Mohawk Power Corp., Quarterly Report (Form 10-Q) (Aug. 15, 1994), *available at* http://www.sec.gov/Archives/edgar/data/71932/0000071932-94-000047.txt.

49 *O'Shanter*, 915 F. Supp. at 563.

50 *Id.* at 563 (citing Consolidated Edison Co. of New York, Inc. Case No. 89-E-1158 (N.Y. Dep't Pub. Serv. Dec. 28, 1993)).

Since the planned location of O'Shanter's plant had been moved after the PSC approved the agreement, the validity of the contract became an issue. Niagara thereupon reduced its buy-out offer to $50,000.[51]

The Niagara-NorCon contract established a floor and ceiling in the second period based on the 1988 LRAC. Within months of NorCon's completion of the plant and the beginning of production, the PSC produced the 1993 LRACs, which were substantially below the 1988 numbers. Both schedules are shown in Table 1. None of the briefs addressed how Niagara (as well as 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 this question in Part VI.

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."[52] 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 assurances to Niagara Mohawk that NorCon will duly perform all

51 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.

52 Brief of Plaintiff-Appellee at 10, NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E.2d 656 (N.Y. 1998) (No. 10518) (on file with the Columbia Business Law Review).

> 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 advance extended by Niagara Mohawk's customers which remains at the end of the Agreement's twenty-five year term.[53]

If NorCon failed to give such assurance within 30 days, Niagara claimed that it would treat the failure as repudiation, and 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.[54]

In its brief, Niagara restated the argument more forcefully:

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53 Demand Letter, *supra* note 30, at 1.

54 *Id.* at 16. In 1999, at the summary judgment hearing, Niagara's counsel claimed that the company was losing $1 million per week. Summary Judgment Hearing, *supra* note 39, at 24.

> 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. [55]

Moreover, Niagara 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.[56]

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 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.[57]

NorCon disputed both the numbers and the notion that it should provide any assurance beyond what was already in the contract. To determine the annual prices, the

55 Brief of Defendant-Appellant at 2–3, NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E.2d 656 (N.Y. 1998) (No. 10618) (on file with the Columbia Business Law Review).

56 Demand Letter, *supra* note 30, at 7.

57 *Id.* at 8–9.

consultants simply plugged in the best current estimate of future prices, namely the 1993 projected LRAC. NorCon objected to this on the grounds that there were large fluctuations in the components making up the LRAC and that projected LRAC did not necessarily correspond to actual prices.[58] NorCon 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.[59] 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, that the deviation could be large.[60] With regard to the adequate assurance claim, NorCon made three points. First, the agreement already took the assurance issue into account. Second, Niagara (and the PSC) knew the risks. Third, NorCon 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

58 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.

Transcript of Record, *supra* note 29, at 318. 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.

59 Brief of Plaintiff-Appellee at 30–31, *NorCon*, 705 N.E.2d 656 (No 10518) (citing Brief for PSC as Amici Curiae Supporting Appellant at 8, *NorCon*, 705 N.E.2d 656 (No. 10518)).

60 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.

refuse to allow a change.[61] Moreover, if the Niagara projections were at all plausible, no third party would be willing to guarantee NorCon's third period obligation.

V. THE LITIGATION

Shortly after receiving the demand letter, NorCon filed suit asking for a declaratory judgment that it need not provide additional assurance.[62] Niagara counterclaimed seeking a declaration that it had properly invoked a right to demand adequate assurance. A second IPP, Encogen, which had entered into a similar three-period, twenty-five-year contract with Niagara also sued, and the two cases were considered together.[63] Niagara sent Encogen a demand letter the same day that it sent one to NorCon, claiming projected losses of $330 million.[64] 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 that in the NorCon agreement.[65] Niagara argued that the right to demand adequate assurance was implicit in the regulatory framework, but the court would have none of it:

> 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

61 "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, *supra* note 37, ¶ 79.

62 *Id.* ¶ 1.

63 Encogen Four Partners, L.P. v. Niagara Mohawk Power Corp., 914 F. Supp. 57 (S.D.N.Y. 1996), *vacated sub nom.* NorCon Power Partners L.P. v. Niagara Mohawk Power Corp., 163 F.3d 153 (2d Cir. 1998).

64 *Id.* at 59–60.

65 *Id.* at 59 n.5 ("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.'").

> 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.[66]

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. On appeal, the Second Circuit certified the question to the New York Court of Appeals, which, as noted in Part I, 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."[67] 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.[68]

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

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66 *Encogen*, 914 F. Supp. at 62 (citations and internal quotation marks omitted).

67 NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 163 F.3d 153, 160 (1988).

68 *Id.*

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.[69] The terms of the settlement will be presented in Part VII.

VI. 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 percent less than if Niagara Mohawk had paid current LRAC for the entire twenty-five-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 twenty-five years and the underlying data are volatile. When 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 which were, as noted, about 50% below the 1988 LRACs which had been incorporated into the

69 1999 Annual Report, *supra* note 23.

contract. NorCon emphasized Niagara's role in the determination of LRAC schedules both in the past[70] and in the new LRAC schedule.[71] According to the complaint:

> 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.[72]

In an affidavit, NorCon's counsel noted:

> 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

70 In support of its motion for summary judgment, NorCon stated that

> Throughout the 1980s, 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 ¶ 69, Encogen Four Partners, L.P. v. Niagara Mohawk Power Corp., 914 F. Supp. 57 (S.D.N.Y. 1996), (No. 94 Civ. 1530), *vacated sub nom.* NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 163 F.3d 153 (2d. Cir. 1998) [hereinafter Affidavit of Thomas J. Hall].

71 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 to half . . . or that the forecast would be off by a factor of 2, however you want to state it." Transcript of Record, *supra* note 29, at 497.

72 Verified Complaint, *supra* note 37, ¶ 64.

> concern over the risk of non-performance in the later years of these contracts . . . .[73]

He also noted that Niagara made internal calculations of the effects of differences between the contractual LRACs and possible future Niagara avoided costs.

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.[74]

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 drafting, was signed in April 1989. While that contract was not approved by the PSC until the 1991 amendments, the obligation from

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73 Affidavit of Thomas J. Hall, *supra* note 70, ¶ 75 (citations and internal quotation marks omitted).

74 Brief of Plaintiff-Appellee at 10 n.5, NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E. 2d 656 (N.Y. 1998) (No. 10518) (on file with the Columbia Business Law Review).

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 LRACs long before the amended agreement was executed. Hence, when the contract was finally executed in 1991, Niagara knew what it was getting into, but it was incapable of avoiding a terrible deal. The original contract, signed in 1989, 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, the 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.[75]

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

[75] FERC Admin. Determination, *supra* note 14.

forecasted fuel costs in the fixed rate structure of long-term contracts."[76] Ironically, fuel prices were not the cause of the decline in either the measured LRAC or the actual avoided costs of Niagara and other utilities; oil prices were actually higher in mid-1992 than they were in 1988.

The 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.[77]

> 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.[78]

Whether parties could produce a contract structure that achieved such a balance is unclear; the NorCon-Niagara agreement did not 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

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76 FERC Admin. Determination, *supra* note 14.

77 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." Order Adopting Rates, Changes, Rules and Regulations for Electric Street Lighting Service, Case No. 94-E-0099 (N.Y. Dep't Pub. Serv. Mar. 20, 1998), 1998 WL 214902, at *8.

78 FERC Admin. Determination, *supra* note 14.

floor were binding for a reasonable length of time, was substantial.

C. Security

Niagara's concerns about the adequacy of its security predated 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 the Supreme Court observed, warrant a court substituting its 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.[79]

In 1988, prior to the NorCon-Niagara agreement, theFERC 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

[79] Niagara Mohawk Power Corp. v. Pub. Serv. Comm'n., 530 N.Y.S.2d 626, 629 (App. Div. 1988) (emphasis added).

> 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.[80]

The 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 Niagara Mohawk Power Co. claims that the New York Public Service Commission estimated the company will incur $180 million in overpayments by 2000 and Pacific Gas and Electric Co. claims it will incur $857 million in overpayments *per year* by 1990.[81]

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.[82] 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 [sic].[83]

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

80 FERC Admin. Determination, *supra* note 14.

81 *Id.* at n.24 (citations omitted).

82 *See* Affidavit of Thomas J. Hall, *supra* note 70, ¶¶ 33–39.

83 *See id.* ¶ 34.

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.

VII. SETTLEMENT

In 1996, while the *NorCon* case was still pending in the Second Circuit, 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 sixteen IPPs, but NorCon and one other opted out. NorCon did, however, agree to continue negotiating in good faith.[84] Niagara paid a substantial price in cash and stock;

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84 Paragraph 2.5 of the Master Restructuring Agreement states:

> 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

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 Niagara Mohawk to terminate, restate or amend 27 PPAs which represented approximately three-quarters of its over-market purchase power obligations. Niagara Mohawk terminated 18 PPAs for 1,092 MW of electric generating capacity, restated 8 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, the Company issued 20.5 million shares of common stock to the IPP Parties.[85]

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 that he projected it would grow to $835 million by 2007; the contract rate in year 16, he said, would be negative $90 per megawatt hour.[86] 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:

> 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 . . . .

Niagara Mohawk Power Corp., Current Report 10 (Form 8-K) (July 9, 1997), *available at* http://secfilings.nyse.com/filing.php?doc=1&attach=ON&ipage=353483&rid=23.

85 1999 Annual Report, *supra* note 23, pt. II, item 7.

86 Transcript of Record, *supra* note 29, at 620–22.

> [I]t 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.[87]

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.

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87 Transcript of Record, *supra* note 29, at 329–30.

VIII. CONCLUSION

Sometimes judges talk too much. Had the Court simply invoked the Restatement, there would have been no basis for criticizing the decision. But it did not. Instead, it 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."[88] 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 (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 twenty-five-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 of Appeals 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 cannot get there from here.

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88 NorCon Power Partners, L.P. v. Niagara Mohawk Power Corp., 705 N.E.2d 656, 661 (N.Y. 1998).

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.[89]

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 with thirty days' 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

89 *NorCon*, 705 N.E.2d at 662.

> 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 scheme, PSC in implementing it, utilities in forecasting LRACs, and QFs in making investment and other decisions.[90]

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.[91] 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

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90 N.Y. State Elec. & Gas Corp. v. Saranac Power Partners L.P., 117 F. Supp. 2d 211, 254 (N.D.N.Y. 2000), *aff'd*, 267 F.3d 128 (2d Cir. 2001) (per curiam).

91 *See, e.g.*, McNeal v. Lebel, 953 A.2d 396 (N.H. 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 the sale of cable and internet assets to be close enough to the sale of goods to extend the adequate assurances doctrine); *In re* Pac. Gas & Electric Co., 271 B.R. 626 (Bankr. 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 (Sup. Ct. 2010) (extending the doctrine of adequate assurances to real estate cases), *aff'd*, 915 N.Y.S. 2d 878 (App. Div. 2011); Merrill Lynch Int'l v. XL Capital Assurance Inc., 564 F. Supp. 2d 298 (S.D.N.Y. 2008) (finding adequate assurances could not be extended to contracts for collateral debt obligation swaps because they are not sufficiently like the sale of goods).

security provision was not negotiated ex ante.[92] That court did not, of course, know that *NorCon* would have failed to qualify.

[92] River Terrace Assocs., LLC v. Bank of N.Y., No. 603745/2002, 2005 WL 3134228, at *7 (N.Y. Sup. Ct.), *aff'd sub nom.* Bank of N.Y. v. River Terrace Assocs., LLC 804 N.Y.S. 2d 728 (App. Div. 2005).