

Can a State Avoid Higher Prices Incurred Under Long-Term Power Supply Contracts? A Study of California's Situation Following Its Energy Crisis

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I. Introduction—The California Energy Crisis

How exactly did the state of California wind up in a situation where it was locked into nearly \$43 billion in long-term energy contracts for the next ten to fifteen years? Before exploring the remedies available to California for escaping a troublesome solution to its energy crisis, it is first necessary to understand what happened. The energy crisis that flared up in California at the turn of the twenty-first century followed 1996 state legislation, California Assembly Bill (The Electric Utility Industry Restructuring Act, or AB 1890), which sought to deregulate wholesale energy markets.¹ Due to California's deregulation legislation, the electricity purchased by utilities became dependent on the wholesale price set by profit-seeking competitive generators, brokers, and marketers.² Moreover, under Assembly Bill 1890 (AB 1890), consumers could select who would provide them with electricity generation, going beyond the geographic areas that their investor-owned utility (IOU) serviced. Consumer choice was not an option available to consumers prior to deregulation.³ Finally, as a result of the reorganization of the transmission of electricity, the newly created California Independent System Operator (California ISO) oversaw the provision of transmission facilities to power generators.⁴ The role of local utilities in dispersing electric power remained unchanged, however.⁵ The original rationale for deregulation stemmed from a desire to reduce retail energy prices and increase the number of energy services available to the state's consumers.⁶

From early 1998 through the summer of 2000, California's energy deregulation succeeded; consumers were able to select their energy suppliers without facing exorbitant charges.⁷ Inevitably, however, wholesale electricity

1. BUREAU OF STATE AUDITS, CAL. STATE AUDITOR, ENERGY DEREGULATION: THE BENEFITS OF COMPETITION WERE UNDERMINED BY STRUCTURAL FLAWS IN THE MARKET, UNSUCCESSFUL OVERSIGHT, AND UNCONTROLLABLE COMPETITIVE FORCES 1 (2001); see Cal. Pub. Utils. Comm'n, *Electricity Crisis: What Problems Are Occurring in the Electricity Industry?*, available at http://www.cpuc.ca.gov/static/industry/electric/faq/elec_crisis_problems.htm (last visited Aug. 25, 2002).

2. Cal. Pub. Utils. Comm'n, *supra* note 1.

3. ENERGY INFO. ADMIN., DEP'T OF ENERGY, PROVISIONS OF AB 1890, available at <http://www.eia.doe.gov/cneaf/electricity/california/assemblybill.html> (last visited Feb 23, 2002) (electricity was generated, transmitted, dispersed, tracked, and charged for by one utility prior to deregulation). Investor-owned utilities include such entities as Pacific Gas & Electric, San Diego Gas & Electric, Southern California Edison, PacifiCorp, Sierra Pacific Power, and Bear Valley Electric. *Id.*

4. *Id.*

5. *Id.*

6. BUREAU OF STATE AUDITS, *supra* note 1, at 1; see ENERGY INFO. ADMIN., DEP'T OF ENERGY, SUBSEQUENT EVENTS—CALIFORNIA'S ENERGY CRISIS, available at <http://www.eia.doe.gov/cneaf/electricity/california/subsequentevents.html> (last visited Feb. 22, 2002).

7. *Id.* (recognizing that the consumer choice and wholesale power market stemming from deregulation functioned without any difficulties from March 1998 through summer 2000).

prices spiraled upward due to causes rooted in both the private and public sectors.⁸ There was no single cause to the energy crisis.⁹

One theme inherent throughout the crisis was a shortage of power.¹⁰ Despite an 11 percent rise in retail sales between 1990 and 1999, there was no corresponding growth in power generation capacity in the state.¹¹ California used power generated beyond its borders in order to meet its demand, including imported hydroelectricity from the Northwest. Ultimately, environmental conditions reduced the hydroelectric power supplied to northern California.¹² Moreover, the amount of power available in 2000 during peak demand periods was further reduced by nonfunctioning generation facilities.¹³ Path 15, the transmission line that connected the surplus power in southern California with power-deficient northern California, was occasionally tied up, inhibiting the flow of electricity to areas of the state that needed it.¹⁴ AB 1890 required the IOUs to purchase all of their power via the California Power Exchange (PX), which operated similar to a commodities market.¹⁵ Deregulation prohibited the IOUs from meeting their power needs and the needs of their customers through long-term energy contracts; the IOUs had to rely solely on the PX.¹⁶ Even when the California Public Utility Com-

8. Cal. Pub. Utils. Comm'n, *supra* note 1; see BUREAU OF STATE AUDITS, *supra* note 1, at 1; ENERGY INFO. ADMIN., *supra* note 6 (there is a general, but not unanimous, consensus on causes of the California energy crisis); cf. *The California Energy Crisis: Impacts, Causes, and Remedies Before the House Comm. on Fin. Servs.*, 107th Cong. 7 (2001) (statement of Rep. Shelley Moore Capito, Member, House Comm. on Fin. Servs.) (criticizing the structure of the California deregulation plan).

9. See ENERGY INFO. ADMIN., *supra* note 6.

10. See *id.*

11. *Id.*; BUREAU OF STATE AUDITS, *supra* note 1, at 2; see also *The California Energy Crisis: Impacts, Causes, and Remedies Before the House Comm. on Fin. Servs.*, 107th Cong. 18 (2001) (statement of Rep. Gary Miller, Member, House Comm. on Fin. Servs.) (despite an 11 percent population increase during the 1990s in California, to a total of 33 million individuals residing in the state, and growth in the electronic commerce industry in the state, there was no accompanying increase in power generation facilities).

12. ENERGY INFO. ADMIN., *supra* note 6; see Statement of Rep. Miller, *supra* note 11 (recognizing that California has had to turn to other states' power-generating facilities in order to meet its own needs).

13. ENERGY INFO. ADMIN., *supra* note 6 (California was without ten gigawatts of generation capability due to the situation in 2000); see *The California Energy Crisis: Impacts, Causes, and Remedies Before the House Comm. on Fin. Servs.*, 107th Cong. 8 (2001) (statement of Rep. Maxine Waters, Member, House Comm. on Fin. Servs.) (there was a dramatic increase in the number of power generators that were temporarily taken out of operation in the first half of 2000 compared to in the past).

14. ENERGY INFO. ADMIN., *supra* note 6.

15. ENERGY INFO. ADMIN., *supra* note 3; see ENERGY INFO. ADMIN., *supra* note 6.

16. *Id.*; see BUREAU OF STATE AUDITS, *supra* note 1, at 1 (the California Public Utility Commission played a role in preventing the IOUs from entering into long-term contracts, which conceivably would have avoided wholesale price increases in the summer of 2000); News Release, Statement of CPUC President Loretta Lynch on Bilateral Power Purchase Contracts (June 18, 2001), available at http://www.cpuc.ca.gov/PUBLISHED/NEWS_RELEASE/7908.htm.

mission (CPUC) allowed the use of long-term energy contracts in March 2000, the IOUs decided against employing them even though they would have shielded price spikes in the summer.¹⁷ Through the PX, which operates as a pool or spot market, price data were readily available, although prices for electricity often fluctuated.¹⁸ The PX left the IOUs vulnerable to increases in the spot-market wholesale prices, which were influenced by shortfalls in electricity and the increased expenses required to generate electricity.¹⁹ As will be noted, the IOUs were unable to pass on to their customers any increases they encountered in spot-market prices for electricity. This led to their financial instability.²⁰ Buyers and sellers on the PX strategically bid on power by, among other methods, purposely underrating the amount of power necessary or available for the next day in order to subsequently raise wholesale energy prices.²¹

Higher natural gas prices and greater expenditures required to meet the state's power plant emissions requirements also helped contribute to the California energy crisis.²² Many consider abnormal weather in 2000 a third cause of the crisis.²³ Finally, company documents released in the wake of the Enron scandal implicated the company for producing artificial shortages during the California energy crisis.²⁴ This market manipulation allegedly contributed to higher prices and blackouts in the California market.²⁵ According to one internal Enron document, market manipulation came in the form of "price-hiking techniques [such] as sham congestion on electricity lines or selling electricity to out-of-state affiliates only to re-import it at higher prices."²⁶ Enron termed one manipulation method the "Death Star," in which it profited by arranging transmission in the reverse direction of congestion, even though the level of energy on the power grid remained the same.²⁷

Throughout the period preceding the summer of 2000, there were minimal regulatory efforts by the CPUC and the Federal Energy Regulatory Commission (FERC), notwithstanding precrisis warnings from the ISO and the PX. At the federal level, when FERC, in December 2000, removed the wholesale

17. BUREAU OF STATE AUDITS, *supra* note 1, at 1–2 (potential savings via the long-term contracts of \$706 million between May 2000 and September 2000).

18. ENERGY INFO. ADMIN., *supra* note 3.

19. ENERGY INFO. ADMIN., *supra* note 6. BUREAU OF STATE AUDITS, *supra* note 1, at 2.

20. ENERGY INFO. ADMIN., *supra* note 6.

21. BUREAU OF STATE AUDITS, *supra* note 1, at 1.

22. ENERGY INFO. ADMIN., *supra* note 6; BUREAU OF STATE AUDITS, *supra* note 1, at 2, 59–60.

23. BUREAU OF STATE AUDITS, *supra* note 1, at 2.

24. Nancy Rivera Brooks et al., *Memo Shows Enron Role in Hiking Prices*, L.A. TIMES, May 7, 2002, at A1; *see also* Craig D. Rose, *FERC Having Identity Crisis*, SAN DIEGO UNION-TRIBUNE, May 12, 2002, at A-1 (allegations that Dynegy and other energy traders also were involved in market manipulation).

25. *Id.*

26. *Id.*

27. *Id.*

price caps that limited the prices that generators could charge, wholesale prices were multiplied by a power of five.²⁸ Two FERC actions stemming from a December 2000 order led to the PX shelving wholesale energy trading by January 31, 2001.²⁹ Moreover, in December 2000, FERC no longer allowed the IOUs to offer their generation of power, via contract, into the PX market.³⁰ Furthermore, FERC ended the PX's wholesale tariffs that allowed the PX to mandate the IOUs' participation in the PX.³¹ Nonetheless, the PX's impact in California's deregulatory environment was significantly reduced by FERC, even though the PX was a staple in the state's energy deregulation efforts.

The multitude of causes of the California energy crisis led to three dilemmas: higher wholesale prices for electricity, power outages (including rolling blackouts), and dire financial conditions for three IOUs.³² Market forces within the private sector led to the notion that, as profit-maximizing entities, generators, marketers, and brokers could increase their prices due to limited supply and a higher demand for electricity.³³ As a result, the IOUs faced higher costs in order to acquire electricity; this necessitated that they offset the situation by increasing their customers' rates.³⁴ In fact, the first signs of a rise in the wholesale price for electricity on the PX began in June 2000.³⁵ The IOUs were unable to pass on the higher prices that they paid on the PX because the deregulated system limited their attempts to raise prices for electricity.³⁶ Nonetheless, AB 1890 allowed the IOUs to eventually increase retail prices for electricity. Soon, San Diego Gas & Electric's (SDG&E) southern California consumers faced higher rates.³⁷ Between July 1999 and July 2000,

28. Cal. Pub. Utils. Comm'n, *supra* note 1.

29. BUREAU OF STATE AUDITS, *supra* note 1, at 2–3.

30. *Id.* at 2.

31. *Id.*

32. Cal. Pub. Utils. Comm'n, *supra* note 1; *see also* Brooks, *supra* note 24 (there were six days of statewide blackouts).

33. *Id.* On the other hand, despite dwindling consumer demand for power in California due to conservation efforts, there was an increase, for the same quantity of power, in the cost of energy generation that the state paid, rising from \$7 billion in 1999 to \$70 billion in 2001. *The California Energy Crisis: Impacts, Causes, and Remedies Before the House Comm. on Fin. Servs.*, 107th Cong. 13 (2001) (statement of Rep. Jay Inslee, House Comm. on Fin. Servs.).

34. Cal. Pub. Utils. Comm'n, *supra* note 1.

35. *See* ENERGY INFO. ADMIN., *supra* note 6 (between December 1999 and December 2000, there was an elevenfold increase in the wholesale price of electricity on the PX, from \$29.71 per megawatt-hour to \$376.99 per megawatt-hour).

36. *Id.*; *see* ENERGY INFO. ADMIN., *supra* note 3 (IOU rates were set at June 1996 levels for their agricultural, residential, industrial, and large commerce purchasers for a duration of time that could last until March 31, 2002). In fact, as of January 1, 1998, residential and small commercial purchasers had their rates lowered for a period that could last up to March 31, 2002. *Id.*; *see The California Energy Crisis: Impacts, Causes, and Remedies Before the House Comm. on Fin. Servs.*, 107th Cong. 32 (2001) (statement of Hon. Isaac C. Hunt Jr., Comm'r, SEC) (liquidity difficulties afflicted the two largest IOUs in California because they could not raise prices that their customers paid).

37. ENERGY INFO. ADMIN., *supra* note 6.

there was a five-cent-per-kilowatt-hour price increase for retail customers of SDG&E before California's legislature imposed a ceiling on what generators could charge their consumers.³⁸ Another ramification of the crisis was a series of rolling blackouts caused by a deficit in operating reserve, in which certain customers had their electricity cut off for a certain period of time.³⁹ Blackouts assured the continued existence of the electric system.⁴⁰ In the first half of 2001, the California ISO occasionally requested the CPUC to implement rotating blackouts because the levels of available energy fell short of demand.⁴¹ The CPUC predicted that one such blackout, on January 17, 2001, would affect customers on a rotating basis for sixty to ninety minutes, between 11:54 A.M. and 9 P.M.⁴² Finally, Pacific Gas & Electric (PG&E), SDG&E, and Southern California Edison (SCE) accumulated heavy financial losses because they encountered increasing expenditures for power on the PX but were unable to charge customers more money.⁴³ In fact, PG&E applied for bankruptcy protection because it could not recover the \$9 billion that it spent for wholesale power. The state also did not reimburse SCE for the \$2.6 billion it used to buy power. Finally, SDG&E was unable to pass the \$447 million that it spent for power onto its customers.⁴⁴

The state of California carried out a series of legislative actions in order to alleviate the problems of the deepening energy crisis.⁴⁵ As a result of the financial predicaments facing the IOUs, particularly PG&E and SCE, several generators hesitated to provide power to them.⁴⁶ Additionally, even when the generators did supply power to the IOUs, the generators feared that the IOUs would not pay for what they received.⁴⁷ One result of the growing energy crisis was that by the beginning of 2001, California had to buy electricity for the IOUs.⁴⁸ Through Assembly Bill 1 of the 2001–02 First Extraordinary Session (AB 1X), the Department of Water Resources (DWR) received the authority to enter into power purchase contracts.⁴⁹ In sum, the

38. *Id.* (the price increased from eleven cents per kilowatt-hour to sixteen cents per kilowatt-hour).

39. *Id.*

40. News Release, Frequently Asked Questions: The CPUC Rotating Outage Program (May 11, 2001), available at http://www.cpuc.ca.gov/PUBLISHED/NEWS_RELEASE/7066.htm.

41. News Release, CPUC Pres. Loretta Lynch Statement on Outages (Jan. 17, 2001), available at http://www.cpuc.ca.gov/PUBLISHED/NEWS_RELEASE/4613.htm.

42. *Id.*

43. ENERGY INFO. ADMIN., *supra* note 6; see Statement of Comm'r Hunt, *supra* note 36 (while one IOU sought bankruptcy protection, another contemplated doing so as well).

44. ENERGY INFO. ADMIN., *supra* note 6; see Statement of Comm'r Hunt, *supra* note 36.

45. See generally ENERGY INFO. ADMIN., *supra* note 6; BUREAU OF STATE AUDITS, *supra* note 1, at 69–81.

46. ENERGY INFO. ADMIN., *supra* note 6.

47. Cf. BUREAU OF STATE AUDITS, *supra* note 1, at 3.

48. *Id.*

49. *Id.* at 70.

DWR entered into fifty-seven long-term power purchase contracts for approximately \$42.6 billion over a ten-year period.⁵⁰ Facing a different climate in the months following the California energy crisis, a report by the Bureau of State Audits of the California State Auditor in late 2001 fueled criticism that the state hastily entered into the long-term power purchase contracts at rates that exceeded those on the spot market.⁵¹

This Note will examine the ability of California to abrogate its obligations to purchase energy at (now) above-market prices in the aftermath of its energy crisis. The Note will then focus on California's authority to enter into these long-term contracts, and whether it can rely on measures for terminating contracts usually reserved for government contracts. Normally, government agencies may use special powers reserved for the Government in a contract, as well as legislative measures, to avoid the agencies' contractual obligations. Subject to limitations, federal agencies have the authority to terminate contracts for convenience when doing so would be advantageous to the Government. Next, the Note will look to two defenses available in breach actions: unconscionability and changed circumstances (including frustration of purpose and impracticability). The Note will address possible litigation under the California False Claims Act and under private contract fraud. In addition, the Note will consider California's potential liability if it were to breach the power purchase contracts.

II. Solution to the California Energy Crisis—Long-Term Power Purchase Contracts

A. *Assembly Bill 1X—Contracting Authority for the DWR*

In November 2001, the United States Justice Foundation filed a lawsuit in Sacramento County Superior Court alleging that California lacked the authority to enter into long-term power purchase contracts.⁵² The Justice Foundation lawsuit also contends that, because California contracted with only a few companies, the state provided those companies with a substantial portion of the California wholesale power market.⁵³ Further, the lawsuit alleges antitrust law violations and conflicts of interest between the generators that are in privity with the contractors and the state.⁵⁴ As previously dis-

50. BUREAU OF STATE AUDITS, CALIFORNIA STATE AUDITOR, HIGHLIGHTS OF REPORT NUMBER 2001-009 — DECEMBER 2001, CALIFORNIA ENERGY MARKETS: PRESSURES HAVE EASED, BUT COST RISKS REMAIN, available at <http://www.bsa.ca.gov/bsa/highlights/2001009h.html>.

51. See *Undoing Costly Power Deals*, L.A. TIMES, Nov. 30, 2001, at 14.

52. Michael B. Marois, *California Faces Suit on Long-Term Power Contracts*, BLOOMBERG NEWS, Nov. 8, 2001.

53. *Id.* In particular, one California resident, Edmund Leon Carboneau, on whose behalf the lawsuit was instigated, alleges that the long-term contracts led to higher utility bills. *Id.*

54. *Id.*

cussed, AB 1X gave the DWR express authority to enter into long-term contracts in order to guarantee that three IOUs (SDG&E, PG&E, and SCE) would have electricity available for their retail customers.⁵⁵ S. David Freeman was at the helm of the DWR in April 2000 when the DWR negotiated the long-term contracts.⁵⁶ Freeman later became the head of a newly created state agency, the California Public Power Authority.⁵⁷ California signed power purchase contracts throughout 2001, particularly during the peak of the energy crisis.⁵⁸ The DWR bought power as late as December 2001 under AB 1X authority.⁵⁹ When the majority of contracts were signed, there were fears that hundreds of blackouts would occur in the summer of 2001, threatening both California residents and its commerce.⁶⁰

The California legislature amended the Water Code through AB 1X, thereby recognizing the problems that the energy crisis brought to the state.⁶¹ Thus, AB 1X addressed the DWR's new role as power purchaser and California's involvement in the energy market.⁶² Although AB 1X amended the Water Code to provide the DWR with the power to enter into the power purchase contracts, it broadly describes "state" involvement in energy markets in section 80000 of the Water Code, not just the DWR's efforts.⁶³ The California Public Power Authority still requires DWR approval prior to entering into long-term power purchase contracts.⁶⁴

The success of AB 1X is subject to debate. Freeman cited the long-term contracts as a way to guard against California facing future jumps in short-

55. BUREAU OF STATE AUDITS, *supra* note 50, at 1. See A.B. 1, 2001–02 Extraordinary Sess. (Cal. 2001) (AB 1X was signed into law by Governor Gray Davis on February 1, 2001).

56. *Energy Questions Again Come to Fore*, ORANGE COUNTY REGISTER, Dec. 21, 2001.

57. Lynda Gledhill & Matthew Stannard, *Davis Now Hopes to Renegotiate Some Energy Contracts*, S.F. CHRONICLE, Oct. 19, 2001, at A19.

58. Michael B. Marois & David Ward, *California Finds State Overpaid for Energy Contracts*, BLOOMBERG NEWS, Dec. 20, 2001.

59. News Advisory, *DWR Announces Additional Long-Term Contracts for Power* (Dec. 10, 2001), available at <http://www.owe.water.ca.gov/newsreleases/2001/12-10-01contracts.html>.

60. BUREAU OF STATE AUDITS, *supra* note 50, at 71.

61. CAL. WATER CODE § 80000 (Deering 2001) ("The furnishing of reliable reasonably priced electric service is essential for the safety, health, and well-being of the people of California. A number of factors have resulted in a rapid, unforeseen shortage of electric power and energy available in the state and rapid and substantial increases in wholesale energy costs and retail energy rates, with statewide impact, to such a degree that it constitutes an immediate peril to the health, safety, life and property of the inhabitants of the state, and the public interest, welfare, convenience and necessity require the state to participate in markets for the purchase and sale of power and energy. . . .").

62. *Id.*

63. *See id.*

64. Virginia Ellis & Nancy Vogel, *State to Seek Renegotiated Energy Deals*, L.A. TIMES, Oct. 18, 2001, at Part 2, p. 1.

term electricity prices.⁶⁵ Ray Hart, Deputy Director of the DWR, credits two contracts as instrumental in avoiding any shortfalls in electricity and rolling blackouts in the state.⁶⁶ On the other hand, both Freeman and Loretta Lynch, president of the CPUC, refuted this very notion in 2000.⁶⁷

AB 1X augmented the DWR's powers considerably, helping to "keep the lights on in California"⁶⁸ at as low a rate as possible.⁶⁹ In contrast to the serious debts encountered by the IOUs, AB 1X assumed that the DWR was creditworthy since DWR-issued bonds created revenues to pay for the generators' electricity and any costs would trickle down to ratepayers.⁷⁰ Under AB 1X, the DWR could purchase electricity and resell it to retail end-use customers, as well as to local publicly owned utilities in certain circumstances.⁷¹ The DWR's long-term contracting authority for power purchases under AB 1X will expire as of January 2, 2003.⁷² The DWR's authority through AB 1X only applies to contracting for electricity purchases; nothing in AB 1X "authorizes [the DWR] to take ownership of transmission, generation, or distribution assets. . . ."⁷³

It is worth noting that, notwithstanding AB 1X, additional statutory provisions exist allowing public agencies in California to enter into agreements for "energy conservation, cogeneration, and alternate energy supply sources" at the agencies' locations.⁷⁴ Furthermore, California public agencies have the authority to enter into energy service contracts if such contracts are in their best interests;⁷⁵ energy service contracts are defined as "contract[s] entered into by a public agency with any person, pursuant to which the person will provide electrical or thermal energy or conservation services to a public agency from an energy conservation facility."⁷⁶ An energy conservation facility is one that is located at a "public building or on land owned by public agencies."⁷⁷ Nonetheless, these additional statutory provisions were not intended to contract for the entire state of California's power purchases. Rather,

65. Dan Walters, *Davis' Problems with Long-Term Power Contracts*, SACRAMENTO BEE, Oct. 24, 2001, at B-9.

66. News Release, Department of Water Resources Signs Long-Term Power Contracts for Peak Power (Aug. 17, 2001), available at <http://www.owe.water.ca.gov/newsreleases/2001/8-17-01powercontracts.html>.

67. Walters, *supra* note 65, at B-9.

68. BUREAU OF STATE AUDITS, *supra* note 50, at 1.

69. *Id.* at 69.

70. *Id.* at 67, 71.

71. A.B. 1, 2001-02 Extraordinary Sess. (Cal. 2001).

72. *Id.*

73. *Id.* Moreover, AB 1X also has provisions dealing with how to finance the long-term power purchases. *Id.*

74. CAL. GOV. CODE § 4217.10 (West 1995).

75. *Id.* § 4217.12.

76. *Id.* § 4217.11(f).

77. *Id.* § 4217.11(e).

these provisions address the state agencies' own need for energy, rather than those of IOUs or statewide consumers. The agreements for the provision of electricity in California under the authority of AB 1X were signed between the DWR and a number of generators, including Enron Corporation, SCE, Pacific Gas & Electric Company, Green Mountain Energy, SDG&E, Reliant Energy Incorporated, and Calpine Corporation.⁷⁸ Specifically, the long-term contracts involve purchases of net-short energy.⁷⁹ Net-short energy is the amount by which the entire consumer demand for electricity by the IOUs' customers exceeds that which the IOUs could provide themselves.⁸⁰ In other words, the power purchase contracts address situations in which the IOU's electricity supply falls short of consumer demand. One estimate held that California purchased power for "one-third of the needs of 24 million people served by Southern California Edison and Pacific Gas & Electric."⁸¹

B. Terms of the Power Purchase Contracts

California's Government Code and Public Contract Code apply to the power purchase contracts "including [provisions relating to], but not limited to[,] advertising and competitive bidding requirements, and prompt payment requirements."⁸² Roughly speaking, the applicable provisions of California's Government Code and Public Contract Code are analogous on a state level to the Federal Acquisition Regulation (FAR), the set of regulations setting forth procedures for government procurement on the federal level. The DWR has discretion over the terms and prices of the contracts, with a set of delineated factors providing guidance.⁸³ The terms of each of the contracts signed under AB 1X authority differ, such as to contract duration, megawatts supplied, and cost per megawatt-hour. For example, the state signed a contract with CalPeak Power on August 17, 2001, for ten years at a cost ranging between \$100 and \$110 per megawatt-hour.⁸⁴ By comparison, a contract with Intercom Energy on December 10, 2001, cost \$45 per megawatt-hour and ran until August 31, 2003.⁸⁵ Some of the contracts involved power that will

78. Marois, *supra* note 52.

79. BUREAU OF STATE AUDITS, *supra* note 50, at 1.

80. *Id.*

81. Ellis & Vogel, *supra* note 64, at Part 2, p. 1.

82. CAL. WATER CODE § 80014(b) (Deering 2001).

83. CAL. WATER CODE § 80100 (Deering 2001) (considerations for the DWR include that "(a) [t]he intent of the program described in this division is to achieve an overall portfolio of contracts for energy resulting in reliable service at the lowest possible price per kilowatt-hour[;] (b) [t]he need to have contract supplies to fit each aspect of the overall energy load profile[;] (c) [t]he desire to secure as much low-cost power as possible under contract[;] (d) [t]he duration and timing of contracts made available from sellers[;] (e) [t]he length of time sellers of electricity offer to sell such electricity[;] (f) [t]he desire to secure as much firm and nonfirm renewable energy as possible").

84. News Release, *supra* note 66.

85. News Advisory, *supra* note 59.

be generated by plants that are not yet built.⁸⁶ California has even contracted for power via wind-generation facilities.⁸⁷

A report from the Bureau of State Audits of the California State Auditor in December 2001 criticized the contracts, finding that “the majority [of them] . . . do not include the terms and conditions one would expect to see in contracts meant to ensure the reliable supply of energy.”⁸⁸ Moreover, the long-term contracts represent a rushed effort to calm the energy crisis; still, the DWR neglected to employ industry-standard terms and conditions.⁸⁹ The report by the Bureau of State Audits questioned why the DWR quickly went from negotiating to executing contracts even though power would not be available under the contracts until four to ten months after signing the agreement.⁹⁰ Rather, the Bureau of State Audits argued that the DWR could have fine-tuned the contractual terms instead of rushing into any binding agreements because there would have been no material consequences in doing so.⁹¹

At the time that the DWR negotiated the contracts, California was in an energy crisis. The state paid more than \$500 million in January 2001 and \$1.4 billion in February 2001 for immediate energy purchases; these expenditures came from California’s General Fund.⁹² The contracts were a way for the state to stabilize the energy market and avoid spending large amounts of money on a daily basis for power.⁹³ It was a better solution for California to lock up its power purchases through contracts instead of making short-term power purchases. Nevertheless, the state’s need to emerge from the energy crisis influenced the seller-friendly long-term contracts.⁹⁴ The terms and conditions of most of the contracts were detrimental to the state’s interests in securing dependable sources of electricity.⁹⁵ The later power purchase contracts were more favorable to the state than the earlier ones.⁹⁶

86. News Release, *supra* note 66.

87. *Id.* (two wind power contracts were agreed to with Whitewater Energy Corporation, lasting twelve years at \$60 per megawatt-hour).

88. BUREAU OF STATE AUDITS, *supra* note 50, at 67.

89. *Id.* at 68.

90. *Id.* at 76.

91. *Id.*

92. *Id.* at 73.

93. *Id.*

94. *Id.* at 91–92.

95. *Id.* at 69. Most of these contracts, which accounted for \$35.9 billion of the \$42.6 billion of power purchased, were negotiated prior to March 2, 2001, meaning that forty contracts were bargained within a span of thirty days. *Id.* at 3, 69. Contracts similar to those entered into by the DWR normally take between two and six months before they are effective, yet the DWR was able to execute fifty long-term contracts involving 606,000 gigawatts of capacity for the following ten years. *Id.* at 74; *see also* Public Utilities Commission v. Sellers of Long Term Contracts to the California Department of Water Resources, 99 F.E.R.C. ¶ 61,087 (2002) (Commissioner Massey, dissenting) (finding that the negotiations and contracts were influenced by rising spot-market prices for power, as illustrated by one obligation by the state to pay \$249 per megawatt-hour).

96. *Id.* at 110.

C. *The Need to Renegotiate the Contracts*

The post-energy crisis situation reflects a different environment than the one in which California signed many of its power purchase contracts. California has emerged from its energy crisis due to its efforts to create additional power plants, buy energy from generators, conserve energy, and benefit from a mild 2001 summer.⁹⁷ Moreover, despite inaction in the first half of 2001, on June 19, 2001, FERC decided to get involved in the California energy crisis by approving a price mitigation plan for the California energy market.⁹⁸ The net result was that by the end of 2001, the spot-market price for electricity fell to levels below those stipulated in the long-term power purchase contracts.⁹⁹

At first, the long-term contracts succeeded in stabilizing the market for electricity in California in the short term.¹⁰⁰ Eventually, the contracts became a concern because more than half of them had durations that lasted from five to ten years.¹⁰¹ Some of the contracts commit California to purchase power for up to twenty years.¹⁰² In addition, the report by the Bureau of State Audits found that many of the contracts contained unfavorable terms for the state.¹⁰³ Between 2003 and 2010, the contracts will supply California with at least 10,000 megawatts of capacity.¹⁰⁴ During the peak of the energy crisis, the price of electricity in California soared up to \$500 per megawatt-hour.¹⁰⁵ By December 2001, the spot-market price for power had dipped to \$30 per megawatt-hour, or less.¹⁰⁶ The cost for power as specified in the long-term contracts is estimated to be 40 percent higher than the prices available during

97. Mark Martin & Lynda Gledhill, *The Energy Crunch: A Year Later*, S.F. CHRONICLE, Dec. 23, 2001, at A1 (noting that 1.5 million homes were capable of being powered by new plants and conservation efforts led to 4,000 fewer megawatts being used on June 21, 2001, as compared to June 21, 2000). See Timothy Egan, *Once Braced for a Power Shortage, California Now Finds Itself with a Surplus*, N.Y. TIMES, Nov. 4, 2001, at 1A29 (due to the energy crisis, California was engaged in a massive conservation program, with an appropriation of \$800 million to accomplish conservation promotion). An executive order gave individuals that cut back 20 percent of their use of power a 20 percent savings on their electric bills. *Id.*

98. *San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services*, 95 F.E.R.C. ¶ 61,425 (2001).

99. *Undoing Costly Power Deals*, *supra* note 51, at 14.

100. BUREAU OF STATE AUDITS, *supra* note 50, at 70.

101. *Id.*

102. Nancy Vogel, *A Lightning Rod in Governor's Race*, L.A. TIMES, Dec. 2, 2001, at Part 2, p. 8.

103. See generally BUREAU OF STATE AUDITS, *supra* note 50, at 197–215.

104. *Id.* at 70.

105. Vogel, *supra* note 102, at Part 2, p. 8.

106. *Id.* One estimate was that electricity on the spot market, in November 2001, was as low as \$19 per megawatt-hour. Egan, *supra* note 97, at 1A29.

2000.¹⁰⁷ Now the DWR, on average, will be purchasing electricity at a price of \$75 per megawatt-hour. Yet when the DWR attempts to unload the net-short energy on the IOUs, it could be doing so at \$16 per megawatt-hour, a situation that in light of the duration of the contracts could lead to a loss of up to \$4 billion by 2010.¹⁰⁸ The contracts do not have tolling agreements, which would lower California's purchase price whenever there is a decrease in the cost of natural gas.¹⁰⁹ One critic contended that California entered into too many contracts.¹¹⁰

Both Governor Gray Davis and the DWR attribute the steep drop in spot-market price to California's involvement in purchasing power for the next ten years.¹¹¹ Critics have suggested that the state is locked into approximately \$43 billion in power purchase contracts for the next ten years at rates far above those in the spot market.¹¹² Furthermore, critics point out that California has purchased electricity at off-peak times, including the "middle of the night and early morning."¹¹³ On the other hand, there is still the potential for price spikes in future summers as demand increases, since not enough "peaker" plants, which operate for a short time, will be available.¹¹⁴ As a result, California could have a surplus of electricity at off-peak periods, while during peak times there may still be an electricity shortfall. This hardly could be the result that the state envisioned when it enacted AB IX. An internal memorandum sent from Thomas Hannigan, director of the DWR, to Freeman took issue with Freeman's efforts to negotiate additional contracts after California had already purchased more electricity than necessary.¹¹⁵ The contracts that concerned Hannigan involved the purchase of power generated by wind and solar sources.¹¹⁶ One possible result stemming from the long-term contracts is that California residents will be charged electricity rates exceeding those on the market, and that the state will be selling its excess

107. Walters, *supra* note 65, at B-9.

108. *Undoing Costly Power Deals*, *supra* note 51, at 14; see Tom Gray, *No End Yet to Energy Crisis in Over-Regulated California*, *INV. BUS. DAILY*, Dec. 4, 2001, at A20 (an analysis of one contract with Sempra Energy mandates that the DWR is to purchase electricity for \$1.2 billion over the unregulated price); Martin & Gledhill, *supra* note 97, at A1 (*San Francisco Chronicle* estimated loss to the state from sale of power until 2010 is over \$3.9 billion).

109. Marois & Ward, *supra* note 58.

110. Martin & Gledhill, *supra* note 97, at A1.

111. *Undoing Costly Power Deals*, *supra* note 51, at 14; cf. Vogel, *supra* note 102, at Part 2, p. 8 (Governor Davis requested that Freeman, when he was the head of the DWR, negotiate contracts averaging \$55 per megawatt-hour).

112. Vogel, *supra* note 102, at Part 2, p. 8.

113. *Id.* Specifically, opponents point out that there are a lot of contracts providing power "24 hours a day, seven days a week." Ellis & Vogel, *supra* note 64, at Part 2, p. 1.

114. Nancy Vogel, *Audit Finds Power Pacts Ill-Conceived, Rushed*, *L.A. TIMES*, Dec. 21, 2001, at Part 2, p. 8.

115. Ellis & Vogel, *supra* note 64, at Part 2, p. 1.

116. *Id.*

supply at a loss.¹¹⁷ Governor Davis¹¹⁸ and Lynch¹¹⁹ have suggested that the long-term contracts be renegotiated; the Bureau of State Audits also recommended that the parties take the same measures.¹²⁰

III. Termination of the Long-Term Contracts

A. California's Approach: State Law and the Long-Term Contracts

There is a "Termination for Cause" clause arising under California Standard Contract Language; this is similar to the standard terms arising under the FAR.¹²¹ Under this "Termination for Cause" provision, the state reserves the ability to cease its contractual obligations without having to pay future compensation if the contractor does not perform the contract's requirements on time as provided.¹²² This provision, therefore, gives California procuring agencies the right to terminate due to the contractor's fault. Nothing in the standard "Termination for Cause" clause or in any of the other standard contract terms under California procurement law provides for the cancellation of a contract due to unfair terms or a change in market price subsequent to execution of the contract.¹²³ Rather, the standard provisions generally focus on actual performance.

Despite the standard clauses that are included in California's procurement contracts, the DWR is unable to terminate the contracts with or lodge penalties against its contracting partners in the power purchases, except for replacement power (i.e., cover) damages.¹²⁴ In fact, the DWR is left with cover damages even when the generators with which the DWR contracts continuously or purposely do not provide power, regardless of demand.¹²⁵ The Bureau of State Audits found that, although cover damages benefit a seller that

117. Ed Mendel, *Critics Blame Governor for Making Energy Crisis Lengthy Financial Burden*, SAN DIEGO TRIBUNE, Dec. 17, 2001, at A-1.

118. Vogel, *supra* note 102, at Part 2, p. 8.

119. Dan Walters, *Will Third Time Be the Charm for Davis on Power Contracts?* SCRIPPS HOWARD NEWS SERVICE, Oct. 22, 2001.

120. BUREAU OF STATE AUDITS, *supra* note 50, at 176 (DWR should renegotiate the terms and price of many of the contracts).

121. California Standard Contract Language, GTC 201—General Terms and Conditions for Private Contractors, available at http://www.ols.dgs.ca.gov/STD_Process/main.asp (last modified Jan. 2, 2002) (term seven, "termination for cause"); see California Standard Contract Language, GTC SF 201—Short Form Contract General Terms and Conditions, available at http://www.ols.dgs.ca.gov/STD_Process/main.asp (term seven, "termination for cause") (last modified Jan. 2, 2002).

122. *Id.*

123. See California Standard Contract Language, GTC 201, *supra* note 121 (term seven, "termination for cause"); California Standard Contract Language, GTC SF 201, *supra* note 121 (term seven, "termination for cause").

124. BUREAU OF STATE AUDITS, *supra* note 50, at 68.

125. *Id.*

does not perform, this remedy is not effective when the good being supplied is electric power implicating net-short energy in a volatile market that has limited quantities of power.¹²⁶ Some of the contracts even have disincentives for the generators to build additional plants, despite the state's interest in creating them.¹²⁷ Thus, the DWR's remedies against a nonperforming generator are more limited than those available in the standard "Termination for Cause" clause.

Many of the power purchase contracts fail to guarantee that the DWR will be able to purchase power when (1) there is an increase in the market price for electricity beyond the contract price or (2) demand for power rises above supply.¹²⁸ Based on the contracts studied, the Bureau of State Audits concluded that California has no right to cancel the contracts if generators have a pattern of failing to provide power; generators may choose not to provide energy either because of their lack of trust of the Government or for fiscal considerations (i.e., it is not profitable for the generator to provide the state with power).¹²⁹ The Bureau of State Audits recommended that the DWR reserve the right to cancel its power purchase contracts and receive damages in the event that a generator either chooses not to or fails to perform. Moreover, the Bureau of State Audits forecasted that the generators would have a greater incentive to fulfill their power supply obligations if the DWR utilizes broader termination rights in its contracts.¹³⁰ Nonetheless, the Bureau of State Audits viewed the long-term power contracts as "seller-friendly," devoid of any rights ensuring the DWR that the generators' performance will be reliable.¹³¹ Because there are no termination rights, the DWR is stuck with nonperforming generators for the long-term durations of the contracts.¹³² The Bureau of State Audits cited two benefits that should have stemmed from the inclusion of termination rights in the contracts: (1) there is guaranteed performance by the sellers due to the amount of money at risk by cancellation and (2) the DWR would get the full value of the contracts.¹³³ Therefore, the state has very limited remedies in terms of being able to terminate its obligations under the contract and is unable to pay lower rates based on the spot market.¹³⁴

California has a statutory provision under the Emergency Termination of Public Contracts Act that allows for the cancellation of its government con-

126. *Id.* at 86.

127. *Id.* at 92–93.

128. *Id.* at 68.

129. *Id.*

130. *Id.* at 87.

131. *Id.* at 87–89.

132. *Id.* at 91.

133. *Id.*

134. *See generally id.*

tracts.¹³⁵ The Emergency Termination of Public Contracts Act is applicable to California's public agencies, including its departments (e.g., the DWR).¹³⁶ By its terms, the Emergency Termination of Public Contracts Act deals with the situation when a national emergency occurs and the contractor's performance is directly or indirectly hindered and thereby made impracticable.¹³⁷ There is nothing in the Emergency Termination of Public Contracts Act that speaks of a statewide emergency, nor any language confronting higher prices or perceived unfair terms.¹³⁸ Clearly, California's situation in the aftermath of the energy crisis is more akin to a bad bargain than a national emergency. As a result, neither the express terms of the contract, nor any provisions in California procurement law, provide California with a way to avoid its long-term power purchase contracts. Moreover, the state failed to include any standard provisions that would ensure reliability by granting termination rights in the event of a generator's nonperformance.

B. Federal Approach: A Comparison

Federal procurement law through the FAR, by contrast, provides a standard termination for convenience clause.¹³⁹ Through this clause, federal contracting agencies reserve the right to end a contract if doing so is in the Federal Government's interest.¹⁴⁰ Even when the termination for convenience clause is not expressly included within a federal contract, it can be read in by a tribunal and held to govern the circumstances of a particular case.¹⁴¹ The end result of a properly utilized termination for convenience clause is to enable the Federal Government to truncate its contractual duties.¹⁴² Could California avoid its contractual obligations to purchase power under the federal system?

Krygoski Construction Co. v. United States redefined earlier limitations on

135. CAL. GOV. CODE § 4400 (West 1995).

136. *Id.* § 4401; see generally CAL. WATER CODE § 80000(b) (Deering 2001) (DWR's authority to implement provisions of AB 1X).

137. *Id.* § 4410 ("In the event a national emergency occurs, and public work, being performed by contract, is stopped, directly or indirectly, because of the freezing or diversion of materials, equipment or labor, as the result of an order or a proclamation of the President of the United States, or of an order of any federal authority, and the circumstances or conditions are such that it is impracticable within a reasonable time to proceed with a substantial portion of the work, then the public agency and the contractor may, by written agreement, terminate said contract.").

138. See generally *id.*

139. Termination for Convenience of the Government, 48 C.F.R. § 52.249-2 (2000).

140. *E.g.*, *id.*

141. *E.g.*, *G.L. Christian & Assoc. v. United States*, 312 F.2d 418, 427 (Ct. Cl. 1963) (applying, by operation of law, a standard termination for convenience clause to a contractual dispute despite the absence of that clause in the contract).

142. Stephen N. Young, Note, *Limiting the Government's Ability to Terminate for Its Convenience Following Torncello*, 52 GEO. WASH. L. REV. 892, 908 (1984).

the termination for convenience clause.¹⁴³ *Krygoski* did not involve a cancellation of a contract in order to obtain a better price. Instead, the U.S. Army Corps of Engineers (the Corps) terminated a contract with Krygoski Construction Company and subsequently resolicited the procurement. The procurement concerned an asbestos abatement; after the Government awarded the plaintiff the contract, the costs for completion of the asbestos removal were greater than originally thought.¹⁴⁴ Retracing the history of the termination for convenience clause, the court in *Krygoski* acknowledged the Court of Claims's previous application of a bad faith test.¹⁴⁵ Therefore, the Court of Claims limited *Torncello* by relying upon a new test: either a "clear abuse of discretion" or bad faith is required in order to overturn a Contracting Officer's decision to terminate for convenience.¹⁴⁶ A changed-circumstances test applies when the Federal Government decides from the outset not to honor its contractual obligations.¹⁴⁷ *Krygoski* recognized that a termination for convenience is allowed because it encourages the Contracting Officer to pursue the objective of "full and open competition."¹⁴⁸ When the solicitation does not accurately reflect the actual work performed, terminating for convenience and resoliciting the procurement better achieves full and open competition.¹⁴⁹ Upon resolicitation, bidders can make offers that are more advantageous to the Government.¹⁵⁰ The Court of Claims, in *Krygoski*, suggested that a termination for convenience in order to "acquire a better bargain from another source" is an example of bad faith.¹⁵¹

Applying these principles hypothetically from the federal sector, California would likely gain little protection after the current crisis passes. Although

143. See generally *Krygoski Constr. Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996). The Navy was held in breach of contract when it asserted a constructive termination for convenience in order to achieve a lower price elsewhere in a requirements contract, despite possessing this knowledge prior to entering into the contract with the plaintiff. *Torncello v. United States*, 681 F.2d 756, 758–59 (Ct. Cl. 1982). The *Torncello* court followed a changed-circumstances approach, which was subsequently modified and distinguished by case law. See *Krygoski Constr.*, 94 F.3d at 1537; *Kalvar Corp., Inc. v. United States*, 543 F.2d 1298, 1302–03 (Ct. Cl. 1976).

144. *Krygoski Constr.*, 94 F.3d at 1538–39.

145. *Id.* at 1541; see *Kalvar Corp.*, 543 F.2d at 1302–03.

146. *Krygoski Constr.*, 94 F.3d at 1543.

147. *Id.* at 1543–44.

148. *Id.* at 1543.

149. See *id.* at 1544–45.

150. See *id.*

151. *Id.* at 1541 (citing *Torncello v. United States*, 681 F.2d 756, 772 (Ct. Cl. 1982)); see Frederick W. Claybrook Jr., *Good Faith in the Termination and Formation of Federal Contracts*, 56 Md. L. Rev. 555, 575 (1997) (quoting *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520 (1961) ("the Government could not avoid the contract merely because it turned out to be a bad bargain")); but see *Kalvar Corp., Inc. v. United States*, 543 F.2d 1298, 1303 (Ct. Cl. 1976) ("mere error on the part of the Government" is not bad faith). It is noteworthy that a contractor that alleges bad faith faces a substantial burden of proof. *Krygoski Constr. Co. v. United States*, 94 F.3d 1537, 1541 (Fed. Cir. 1996) (citing *Kalvar*, 543 F.2d at 1301).

California did not include the standard "Termination for Cause" term in its power purchase contracts, the federal system would enable such a clause to be read in by operation of law. As a result, California could expect the reliability from the generators that accompanies broad termination rights in power purchase contracts. Still, under the federal system, California would face the limitations imposed by *Krygoski* on its ability to terminate at will, or for convenience. It is likely that California intended to perform its contractual obligations from the outset; AB 1X gave the DWR the authority to enter into long-term contracts. Even though AB 1X arose during the energy crisis, the bill's language reflects a broad desire to achieve stability in the provision of power.¹⁵² California sought to "keep the lights on" through AB 1X, but it needed a long-term solution; the durations of the contracts reflect this objective. Otherwise, the crisis could eventually return. Thus, the situation is one governed by *Krygoski's* bad-faith test, rather than *Torncello's* changed-circumstances approach. The aforementioned criticism of the contracts reflects a belief that they were a "bad bargain," and *Krygoski* limits the ability of the Federal Government to terminate contracts because they are financially unfavorable. By analogy, there is no avenue in the federal system to allow California to cancel the contracts under "bad bargain" circumstances.

IV. Constitutional Limitations on Legislative Action

A. Contracts Clause

The California Constitution prohibits the enactment of any "law impairing the obligation of contracts."¹⁵³ Similarly, the U.S. Constitution's Contracts Clause contains nearly identical language: No state may pass a "Law impairing the Obligation of Contracts."¹⁵⁴ The Contracts Clause in the U.S. Constitution and the California Constitution both allow some impairments of contractual duties.¹⁵⁵ States are allowed to act as private parties when contract breaches are involved; not every contract breach by a state is unconstitutional.¹⁵⁶ The Constitution focuses solely on impairments of contractual duties, rather than breaches of contract.¹⁵⁷ Under the "availability-of-remedy" test, there is no impairment if a contract breach occurs but a party is still bound to pay damages.¹⁵⁸ Hence, if California breaches its power purchase contracts and a tribunal finds it liable, there is no constitutional violation (i.e., impairment). The Supreme Court of California has followed the

152. See CAL. WATER CODE § 80000 (Deering 2001).

153. CAL. CONST. art I, § 9.

154. U.S. CONST. art. I, § 10, cl. 1.

155. *Allen v. Bd. of Admin. of the Pub. Employees' Ret. Sys.*, 665 P.2d 534, 537-38 (Cal. 1983); *United States Trust Co. v. New Jersey*, 431 U.S. 1, 21 (1977).

156. *TM Park Ave. Assocs. v. Pataki*, 214 F.3d 344, 348-49 (2d Cir. 2000) (quoting *Horwitz-Matthews, Inc. v. City of Chicago*, 78 F.3d 1248, 1250 (7th Cir. 1996)).

157. *Id.* at 349.

158. *Id.*

approach taken by the Supreme Court in analyzing a potential impairment of the Constitution's Contracts Clause.¹⁵⁹ California's contract impairment cases are largely based on federal case law.¹⁶⁰

B. Impairments of Contractual Obligations

One can find unconstitutional impairment even if contractual expectations are not completely obliterated by legislative action.¹⁶¹ There may not be an unconstitutional impairment, however, if the state action confines a party to anticipated bargains from the contract.¹⁶² Courts will analyze legislation in greater detail if they feel it harshly impairs contractual duties.¹⁶³ One factor used to determine the severity of the impairment is whether the plaintiff's industry was once regulated.¹⁶⁴ Therefore, it is worth mentioning that the state's efforts to deregulate its energy markets preceded the California energy crisis. California's contract impairment cases are largely based on federal case law.¹⁶⁵

United States Trust Company v. New Jersey invoked the question of whether a state legislature's removal of a provision that protected bondholders was an impairment of that state's obligations under the Constitution.¹⁶⁶ The Supreme Court established an analysis that the Supreme Court of California and the Court of Appeal of California follow in determining whether California itself has violated either the Constitution or the California Constitution.¹⁶⁷ The Constitution's Contracts Clause applies to states' contracts and any attempts to alter them.¹⁶⁸ A "technical impairment" does not automatically translate into a violation of the Constitution's Contracts Clause.¹⁶⁹

United States Trust allows a state to alter its contractual obligations without triggering a constitutional violation if the action is "reasonable and necessary to serve an important public purpose."¹⁷⁰ A legitimate public purpose for a legislative action includes fixing a widespread social or economic dilemma.¹⁷¹ Courts are not wholly reliant upon a state's determination of what is "rea-

159. *CalFarm Ins. Co. v. Deukmejian*, 48 Cal. 3d 805, 830–31 (1989); see *Hellinger v. Farmers Ins. Exch.*, 111 Cal. Rptr. 2d 268, 280–83 (Cal. Ct. App. 2001).

160. *Id.* at 279–81.

161. *Energy Reserves Group, Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 411 (1983).

162. *Id.*

163. *Id.*

164. *Id.*

165. *Hellinger v. Farmers Ins. Exch.*, 111 Cal. Rptr. 2d 268, 279–81 (Cal. Ct. App. 2001).

166. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 3 (1977).

167. *E.g.*, *Allen v. Bd. of Admin. of the Pub. Employees' Ret. Sys.*, 665 P.2d 534, 537–41 (Cal. 1983); *Valdes v. Cory*, 189 Cal. Rptr. 212, 224–26 (Cal. Ct. App. 1983).

168. *United States Trust*, 431 U.S. at 17.

169. *Id.* at 21.

170. *Id.* at 25.

171. See *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 247, 249 (1978).

sonable and necessary” when the state is a party to the contract.¹⁷² The Supreme Court based findings of necessity on whether (1) the governmental entity could have accomplished the result through “a less drastic modification” and (2) another course would meet the state’s objective absent any changes to the contract.¹⁷³ Furthermore, the Court considered additional factors in evaluating whether the impairment was unconstitutional: (1) how much time elapsed between the contract’s execution and attempted abrogation of it; (2) the foreseeability of revocation of the contract; (3) whether something extreme occurred necessitating legislative action; and (4) the length of time that the state’s goal existed.¹⁷⁴

The Supreme Court had an opportunity to further analyze the Contracts Clause of the Constitution in *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*¹⁷⁵ *Energy Reserves Group* involved a claim that a Kansas statute that set a maximum lawful price for certain intrastate natural gas contracts unconstitutionally impaired an agreement between Kansas Power & Light Company, a public utility, and Energy Reserves Group.¹⁷⁶ The Court applied a three-part test to supplement earlier case law: (1) whether the state action substantially impaired an agreement between two contracting parties (severity of the impairment); (2) whether the state can justify its action due to a legitimate public purpose; and (3) whether the impairment of “the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying the legislation’s adoption.”¹⁷⁷

The Supreme Court of California applies the *Energy Reserves Group* analysis.¹⁷⁸ Moreover, the *Energy Reserves Group* Court found that the natural gas industry, despite passive state involvement in the price of natural gas, was heavily regulated due to a system of extensive state oversight.¹⁷⁹ The Court recognized that, because the Kansas statute was an impairment, Kansas had a “significant and legitimate” sovereign interest in implementing its police power to shield customers from the increase in natural gas prices brought upon by deregulation.¹⁸⁰ The natural gas contracts at issue included

172. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 25–26 (1977).

173. *Id.* at 29–30.

174. *See id.* at 31–32.

175. *See generally* *Energy Reserves Group, Inc. v. Kan. Power & Light Co.*, 459 U.S. 400 (1983).

176. *Id.* at 405–09.

177. *Id.* at 411–13.

178. *CalFarm Ins. Co. v. Deukmejian*, 48 Cal. 3d 805, 830–31 (1989); *see* *Hellinger v. Farmers Ins. Exch.*, 111 Cal. Rptr. 2d 268, 280–83 (Cal. Ct. App. 2001).

179. *Energy Reserves Group*, 459 U.S. at 413–14 (Federal Power Commission had authority as to “just and reasonable” interstate natural gas rates, which hindered any intrastate rise in price).

180. *Id.* at 416–17 (increases in gas rates could adversely affect consumers that rely upon gas heat). The Kansas statute was compared against a federal scheme of natural gas regulation. *Id.* at 418.

provisions that could change the terms based on state and federal law.¹⁸¹

As mentioned earlier, California's actions in 1996 were expected to minimize the state's involvement in energy markets. On the other hand, the system that resulted after 1996, involving the CPUC, California ISO, and PX, reflects continuing state involvement in the power industry. California's dilemma is more akin to the situation in *United States Trust* than *Energy Reserves Group*; California is not seeking to regulate the private contracts between parties but rather is concerned with its own obligations. While legislative action to remove the burden of the power purchase contracts could possibly resonate throughout California's energy markets, the chief concern is over the state as a contracting party.

The *United States Trust* analysis weakens California's ability to enact legislation meant to lessen the burden of the power purchase contracts. First, as will be discussed below, a successful renegotiation of the contracts is a "less drastic modification." Renegotiation could be mutually beneficial to both California and the contracting generators. Additionally, state legislators were strongly considering how to approach renegotiation of the contracts.¹⁸² It appears that California would be prematurely enacting legislation to lessen the impact of the power purchase contracts without significant efforts to renegotiate them. Second, renegotiation is a viable option that would uphold the existence of the contracts without completely voiding California's duty to pay the generators for electricity. The Bureau of State Audits faults the DWR for entering into the contracts without guaranteeing the availability of power in the future.¹⁸³ California can conceivably renegotiate to ensure a steady flow of electricity over the lives of the contracts without significantly altering the contracts' prices. Legislative action by California would be a "substantial impairment" of the contracts; if the state abrogates the contracts, then the generators would lack agreements that they contracted for at a time when the state needed to "keep the lights on." As in *Energy Reserves Group*, California has a legitimate need to protect its citizenry from high electricity prices.¹⁸⁴ Unlike in *Energy Reserves Group*, however, California has already taken action to avoid rising power prices by entering into the contracts; the contracts are a safeguard against increasing market prices.

California entered into most of the unfavorable contracts in the first half of 2001, during the crisis,¹⁸⁵ but a year later they no longer appear to be bargains.¹⁸⁶ By contrast, in *United States Trust*, the Court found an unconstitutional impairment where twelve years elapsed between the contract's ex-

181. *Id.* at 416 (these terms were similar to those in other gas sale contracts).

182. Vogel, *supra* note 102, at Part 2, p. 8; Walters, *supra* note 119.

183. BUREAU OF STATE AUDITS, *supra* note 50, at 67.

184. See *Energy Reserves Group, Inc. v. Kan. Power & Light Co.*, 459 U.S. 400, 413–14 (1983).

185. BUREAU OF STATE AUDITS, *supra* note 50, at 69, 74.

186. *Undoing Costly Power Deals*, *supra* note 51, at 14.

ecution and the legislative efforts to abrogate the state's obligations.¹⁸⁷ In spring 2001, it may have been foreseeable that the state would eventually emerge from the energy crisis sooner or later. FERC's involvement reflects federal intervention in order to forestall an expanding energy crisis; FERC stepped in during summer 2001.¹⁸⁸ Furthermore, the provisions of AB 1X reflect DWR power-purchasing authority in order to stave off the energy crisis.¹⁸⁹ It is likely that, given the efforts taken on the state and federal levels, the crisis would eventually cease, with electricity prices subsequently falling. This is a situation where the state took action (through AB 1X) with knowledge of the likely consequences (i.e., end of the energy crisis and lower electricity prices).¹⁹⁰ As discussed *supra*, the change in the California energy markets occurring in late 2001 did not possess the detrimental characteristics of the crisis: bankrupt IOUs, demand exceeding supply, and fears of continuing blackouts. Rather, the state now faces a bad bargain and has to determine how to minimize the impact.

Finally, *Midland Realty Co. v. Kansas City Power & Light Co.* recognized a state's power to repeal and replace utility rates that are stipulated in contractual obligations.¹⁹¹ Rates put forth by a state utility commission or a public utility may have the same "force and effect" as if a legislature had set them.¹⁹² Therefore, a state has the power to raise public utility rates beyond those set forth in a private contract, and the parties are bound by contract to honor them.¹⁹³ One can distinguish *Midland Realty* from the situation that confronts California. *Midland Realty* involved a private contract between a power company and a customer, neither of which was a governmental entity.¹⁹⁴ In California's situation, the state is the customer. It is a different situation than in *Midland Realty* if California were to act through the CPUC and set new rates to apply retroactively to the power purchase agreements. Instead, the situation would more closely follow that of *United States Trust*, and California could face an uphill battle.¹⁹⁵

V. Private Contract Remedies

In *Mobil Oil Exploration & Producing Southeast, Inc. v. United States*, the Supreme Court recognized that the Federal Government faces the same re-

187. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 9–14, 32 (1977).

188. *Cf. San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Services*, 95 F.E.R.C. ¶ 61,425 (2001).

189. CAL. WATER CODE § 80000 (Deering 2001) ("reliable reasonably priced electric service").

190. *See United States Trust*, 431 U.S. at 31–32.

191. *Midland Realty Co. v. Kan. City Power & Light Co.*, 300 U.S. 109, 113 (1937).

192. *Id.* at 114.

193. *See id.* at 113–14.

194. *Id.* at 110–11.

195. *See generally United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977).

sponsibilities as a private party does under contract law.¹⁹⁶ There, the Court relied upon the *Restatement of Contracts* along with other secondary source authorities in rendering its decision.¹⁹⁷ In a similar vein, the rights and obligations, including defenses, confronting private parties impact California's agencies. This section is concerned with California's ability to apply defenses to private contract breach actions.

A. Unconscionability

Loretta Lynch, president of CPUC, condemned the long-term power purchase contracts as being "unconscionably high."¹⁹⁸ Upon ruling that a term or agreement is unconscionable, a tribunal applying California contract law may choose whether to nullify an entire contract or a specific provision, or to restrict the use of a certain provision.¹⁹⁹ California case law defines unconscionability as involving "an absence of meaningful choice on the part of one of the parties together with contract terms [that] are unreasonably favorable to the other party."²⁰⁰ There are procedural and substantive facets of unconscionability.²⁰¹ The drafter of a form contract bears the burden of proof as to the other party's knowledge of unconscionable terms contained therein.²⁰² The DWR provided the form contracts that the state used for the power purchases.²⁰³ A court will look for both procedural and substantive unconscionability before it grants appropriate relief, although it can substitute a greater showing of one element for less proof of another.²⁰⁴

Substantive unconscionability arises when a contract's provision solely favors one party over the other for no legitimate reason and reapportions the "risks of the bargain in an objectively unreasonable or unexpected manner."²⁰⁵ As previously discussed, the Bureau of State Audits' report in December 2001

196. Thomas J. Madden & Andrew S. Gold, Feature Comment, *Supreme Court Holds Government to Same Standards as Private Party in Breach Action; Future of "Sovereign Acts" Doctrine in Doubt*, 42 *Gov'T CONTRACTOR* ¶ 277 (2000) (analyzing impact of *Mobil Oil Exploration & Producing Southeast, Inc. v. United States*, 120 S.Ct. 2423, 147 L.Ed.2d 815 (2000)). [ok?]

197. *Id.* (benefits of consistency in government contract law by reliance on principles applicable to private parties).

198. Walters, *supra* note 65, at B-9.

199. CAL. CIV. CODE § 1670.5(a) (Deering 2001); see *Ilkhchooyi v. Best*, 45 Cal. Rptr. 2d 766, 774-75 (Cal. Ct. App. 1995) (noting that unconscionability is available for both commercial and noncommercial contracts).

200. *Ilkhchooyi*, 45 Cal. Rptr. 2d at 775 (quoting *A&M Produce Co. v. FMC Corp.*, 186 Cal. Rptr. 114 (Cal. Ct. App. 1982)).

201. *Id.*

202. *Id.*

203. BUREAU OF STATE AUDITS, *supra* note 50, at 104.

204. *Samura v. Kaiser Found. Health Plan, Inc.*, 22 Cal. Rptr. 2d 20, 27-28 (Cal. Ct. App. 1993) (quoting *Dean Witter Reynolds, Inc. v. Superior Court*, 259 Cal. Rptr. 789, 795 (Cal. Ct. App. 1989)).

205. *Ilkhchooyi v. Best*, 45 Cal. Rptr. 2d 766, 775 (Cal. Ct. App. 1995) (quoting *A&M Produce Co. v. FMC Corp.*, 186 Cal. Rptr. 114, 122 (Cal. Ct. App. 1982)).

criticized the terms of many of the power purchase contracts as being unfavorable to the state.²⁰⁶ The contracts did not guarantee that generators will always provide the DWR with power, a significant concern considering the allegations that generators purposely withheld their supply during the energy crisis.²⁰⁷ The most recent contracts signed under AB 1X authority, however, reflect terms monitoring the generators' performance, including rights of inspection and progress reports.²⁰⁸ Despite the absence of provisions allowing the DWR to terminate the contracts in the event that a generator does not develop additional generation or there is a continuous or deliberate failure to supply power, the earlier contracts guarantee the generators steady profits for the future.²⁰⁹ The earlier DWR contracts employ an incentive-based strategy instead of penalties and coercive remedies in the event that a generator fails to meet its contractual obligations.²¹⁰ No incentives exist to address generator performance beyond the written letter of the contract. These incentives could include a clause mandating completion of additional plant facilities ahead of time.²¹¹ Rather, the provisions are consistent with those expected in a seller-friendly contract, including terms that guarantee the generators substantial revenue over an extended time period, price terms that are beneficial from the generators' perspective, lower risk that the contractors will face increased generation and transportation costs, and superior termination rights for the generators.²¹²

Unlike the provisions included in its request for bids, the DWR bears risks and costs that are normally allocated to sellers (i.e., the generators) during the generation and predelivery stages of performance.²¹³ In the event that California's taxes adversely impact the generation or transportation of electricity, the DWR pays for any increased costs.²¹⁴ The DWR is also responsible for additional amounts that the generators have to pay due to action by the Federal Government or Federal Agency (e.g., FERC), or because of the costs of environmental upgrades and emissions charges.²¹⁵ A contract with Dynegy

206. See BUREAU OF STATE AUDITS, *supra* note 50, at 244.

207. *Id.* at 88.

208. *Id.* A contract with Coral mandates that the generator give the DWR updates on its units' steps towards performance, thereby providing the DWR with a chance to alleviate any difficulties encountered. *Id.* In a Calpine SJ agreement, the DWR reserved the right to inspect the performance of the generator's units twice annually. *Id.* at 88–89.

209. *Id.* at 89–94. Some of the contracts require generators to build additional facilities to supply power in the state. *Id.* at 91.

210. *Id.* at 94.

211. *Id.*

212. *Id.*

213. *Id.* at 96.

214. *Id.*

215. *Id.* at 96, 101. For example, the DWR is responsible for any rise in the contract price caused by a governmental action increasing Calpine's cost of service beyond fifty cents per megawatt-hour. *Id.* at 96. Additionally, the agreements with Williams similarly allocates increased costs of service to the DWR. *Id.*

astonished the Bureau of State Audits because it was contrary to the purposes of AB 1X for the DWR to guarantee the flow of electricity for a generator that it contracted with, either during or after the contracts' performance.²¹⁶ Specifically, the Dynegy contract at issue requires the DWR to take on the role as power provider when the generator's performance of the contract limits its ability to meet its customers' needs.²¹⁷ The DWR may encounter high prices even though the generators lack any incentives to build additional plants or provide power under the agreements.²¹⁸ Again, AB 1X sought to supply the state's consumers with "reasonable" prices.²¹⁹

The generators can cancel the contracts if the DWR does not meet its duty to purchase power.²²⁰ Furthermore, the state promised the generators that the DWR will make its payments because of the bond and creditworthiness terms in the agreements.²²¹ If the DWR does not have enough revenue in its fund to make purchases, the generators can refuse to provide it with power.²²²

There are two basic types of contracts with provisions addressing the generators' nonperformance. First, unit-contingent contracts forgive a generator's nonperformance when there is an unexpected event or a generator's units are taken off-line. Firm energy with liquidated-damages contracts (also known as firm LD contracts), alternatively, provide a force majeure clause specifying certain situations that will excuse a generator's nonperformance.²²³ Although firm LD contracts better serve reliability concerns than unit-contingent contracts, the Bureau of State Audits found that the DWR had entered into more of the latter type of agreement.²²⁴ Reliability is a concern with unit-contingent contracts, because they are more likely to enable generators to decide not to perform.²²⁵

In addition, the generators have greater rights to cancel the agreements in the event of a default, as compared to the DWR.²²⁶ Under an event of default, the generators are able to receive the remaining compensation owed under the entire contract at once, while having any nonperformance excused.²²⁷ A generator can announce an event of default if the DWR does not meet a "material" term of the contract, make a required payment absent written notice, or meet the agreement's creditworthiness obligations.²²⁸ Only

216. *Id.*

217. *Id.*

218. *Id.*

219. CAL. WATER CODE § 80000 (Deering 2001).

220. BUREAU OF STATE AUDITS, *supra* note 50, at 97.

221. *Id.*

222. *Id.*

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.* at 98.

227. *Id.*

228. *Id.* at 99.

the generators have the discretion to declare an event of default.²²⁹ California could owe a great deal of money immediately if a generator declares an event of default.²³⁰ One event of default could lead to a domino effect bringing about subsequent declarations of events of default by other generators.²³¹ It is worth noting that the DWR could benefit from a generator announcing an event of default, such as when additional costs would otherwise raise contract price (i.e., new taxes imposed by the Federal Government) or if the state buys too much electricity.²³² Hence, the terms of the earlier contracts overwhelmingly favor the generators (sellers) and expose the DWR to potentially higher costs and nonperformance; this meets the definition of substantive unconscionability.

Procedural unconscionability is concerned with both “(1) oppression aris[ing] from an inequality of bargaining power that results in no real negotiation and ‘an absence of meaningful choice’ . . . ; [ok to add single quote? See n. 233 below] and (2) surprise” from the placement of the negotiated contract terms.²³³ The DWR employed standard form contracts in its power purchases, which were seller-friendly and devoid of any terms to guarantee the reliability of the generators’ performance.²³⁴ The Bureau of State Audits suggested that because of the anticompetitive market, the DWR’s contracts did not meet the state’s goals.²³⁵ California’s needs would have been better met by provisions affecting the generators’ dependability.²³⁶

The DWR’s negotiating team was more concerned with meeting the DWR’s business goals than in including typical long-term contract provisions.²³⁷ A large number of the contracts were also negotiated while the state was in a weak bargaining position during its energy crisis.²³⁸ The DWR negotiated seller-friendly contracts in order to ensure the supply of power by the generators.²³⁹ Each generator had considerable legal representation and was a sophisticated entity.²⁴⁰ On the other hand, the DWR was unable to take advantage of its statutorily granted authority to hire additional support

229. *Id.* at 99, 102.

230. *See id.* at 98, 99–100 (an event of default under a Calpine agreement would require the state to immediately pay \$1.8 million).

231. *Id.* at 100.

232. *Id.* at 101–02.

233. *Ilkhchooyi v. Best*, 45 Cal. Rptr. 2d 766, 775 (Cal. Ct. App. 1995) (quoting *A&M Produce Co. v. FMC Corp.*, 186 Cal Rptr. 114 (Cal. Ct. App. 1982)) (internal quotation marks omitted).

234. BUREAU OF STATE AUDITS, *supra* note 50, at 103.

235. *Id.*

236. *Id.*

237. *Id.* at 3, 209.

238. *See id.* at 3.

239. *Id.*

240. *Id.* at 109, 184.

staff because of how quickly the agreements were hammered out.²⁴¹ The Bureau of State Audits could not predict if and how the generators would have responded to the inclusion of terms that secured reliability; the DWR never even brought up the subject.²⁴²

In sum, the terms of the agreements heavily favor the generators, yet the state is left with few assurances that their contracting partners will perform. These contractual provisions are significant in calculating substantive unconscionability under California contract law. At the same time, AB 1X gave the DWR the directive to achieve reliable sources of power at reasonable costs; still, the department did not fully utilize its resources. Although the DWR provided the terms of the contracts, the department appears to have acted as a party in a weak bargaining position. The Bureau of State Audits faulted the DWR for not meeting the objectives of AB 1X.²⁴³ A tribunal may determine that the contracts reflect substantive and procedural unconscionability, yet this defense is weakened by the broad mandate to the DWR by AB 1X, which clearly was not a barrier to the inclusion of additional buyer-friendly terms. Further, the Bureau of State Audits implied that the DWR had the ability to include buyer-friendly terms, but did not even attempt to do so in some instances.²⁴⁴ For example, irrespective of the parties' disparate bargaining positions, the DWR never attempted to negotiate for provisions that would guarantee the generators' performance.²⁴⁵ The "unconscionable contracts," therefore, may have less to do with the parties' positions than with the DWR's approach to purchasing power.

B. Changed Circumstances

Section 1511 of the California Civil Code provides a framework for excusing performance on the basis of changed circumstances.²⁴⁶ Changed circumstances include frustration of purpose and impracticability.²⁴⁷ The doctrine of changed circumstances can excuse performance of a contract "in whole or in part."²⁴⁸

241. *Id.*; see CAL. WATER CODE § 80000(b) (Deering 2001) ("[i]n order for the [DWR] to adequately and expeditiously undertake and administer the critical responsibilities established in . . . [the amendment by AB 1X] it must be able to obtain, in a timely manner, additional and sufficient personnel with the requisite expertise and experience in energy marketing, energy scheduling, and accounting").

242. BUREAU OF STATE AUDITS, *supra* note 50, at 110.

243. *Id.* at 3.

244. See generally *id.* at 110.

245. *Id.*

246. See generally CAL. CIV. CODE § 1511 (Deering 2001).

247. See generally *id.*

248. *Id.*

1. Impracticability

Impracticability is a recognized defense in California when fulfillment of the contractual obligations by a party may become too costly or challenging.²⁴⁹ Unless the facts indicate that the situation is of the “gravest importance,” however, the doctrine of impracticability may not be available when the parties could have considered the changed circumstance at the time of bargaining.²⁵⁰ Even if the changed circumstance was not foreseeable at the time of negotiations, the doctrine of impracticability may still not apply.²⁵¹ A mere increase in costs and a heavier burden in performing do not always excuse a performance as impracticable.²⁵² There is no indication that public criticism of the agreements makes performance by California too burdensome. The criticism focuses on the elevated costs of the agreements when compared to the spot-market price of power on a long-term basis.²⁵³ As a sovereign, California can pay for the power purchase contracts, regardless of how much the state is charged. Finally, the possibility that the spot-market price of power would eventually drop weakens the impracticability defense, regardless of the spot price when the agreements were executed. By its terms, AB 1X reflects the view that DWR action would stabilize the market and thwart the rising price of power that resulted from the energy crisis.

2. Frustration of Purpose

Under the doctrine of frustration of purpose, both parties are capable of fulfilling their contractual obligations. Under this defense, the main justification for the parties’ duties “has been frustrated by an unanticipated supervening circumstance, thus destroying substantially the value of performance by the party standing on the contract.”²⁵⁴ Thus, frustration of purpose excuses nonperformance. A frustration of purpose arises when the original objective causing both parties to enter into the contract no longer exists due to no fault of the party using this doctrine.²⁵⁵ Obviously, the generators entered into the contracts due to their profit-seeking motives. Of course, it did not hurt that the DWR sought the energy supply agreements on seller-friendly terms.²⁵⁶ AB 1X defined the state’s entry into power purchasing as one geared towards stabilizing California’s energy markets.²⁵⁷ Nevertheless, the Bureau of State Audits criticized the DWR’s negotiations with the generators.²⁵⁸ In particular, the Bureau of State Audits faulted the DWR for not providing the

249. *Kennedy v. Reece*, 37 Cal. Rptr. 708, 712 (Cal. Dist. Ct. App. 1964).

250. *Id.*

251. *Id.* at 713.

252. *Id.*

253. *Undoing Costly Power Deals*, *supra* note 51, at 14.

254. *Cutter Labs., Inc. v. Twining*, 34 Cal. Rptr. 317, 324 (Cal. Dist. Ct. App. 1963).

255. *Brown v. Oshiro*, 156 P.2d 976, 978 (Cal. Dist. Ct. App. 1945).

256. See BUREAU OF STATE AUDITS, *supra* note 50, at 83–110.

257. CAL. WATER CODE § 80000 (Deering 2001).

258. See BUREAU OF STATE AUDITS, *supra* note 50, at 83–110.

state with termination rights beyond cover damages.²⁵⁹ Hence, it appears that the DWR bears the blame for not securing reliable sources of power; frustration of purpose does not apply when the party seeking to use the defense is at fault. To the extent that California's purpose is frustrated by the likelihood that the generators can avoid performance, the DWR has to look at its own efforts in negotiating the agreements.

Even without the reliability provisions, Governor Davis credited the contracts with reducing the spot-market price of electricity.²⁶⁰ Thus, insofar as the energy markets in California have stabilized, the state's purpose for entering into the contracts has not been frustrated. This is the case despite concerns that consumers will ultimately face costs higher than those in the spot market because the state is no longer facing an energy crisis.

VI. False Representations

It is beyond the scope of this paper to consider whether there was a potential violation of the relevant federal fraud statutes due to the energy companies' alleged manipulation of the California energy market.²⁶¹ One commentator stated that the state's best probability for success would be to demonstrate a "massive collusion or manipulation" by generators to reach agreements by the state for the costly power purchase contracts.²⁶² Still, California already filed a lawsuit in San Diego Superior Court asking the court to cancel a ten-year, \$7 billion contract with Sempra and impose damages.²⁶³ This lawsuit charges fraud by Sempra and also alleges that the energy company is not fulfilling its contractual duty to construct additional power plants.²⁶⁴ In its defense, Sempra states that it is constructing generating plants, even though the contracts have no such requirement.²⁶⁵ California acknowledges acceptance of the high rates in the Sempra contract in order to assist the company in building more power plants.²⁶⁶

259. *Id.*

260. *Undoing Costly Power Deals*, *supra* note 51, at 14.

261. See Brooks, *supra* note 24 (Senator Dianne Feinstein, D-California, claimed that there may be federal fraud violations).

262. Tim Reiterman, *State Disputes Long-Term Power Pacts*, L.A. TIMES, Feb. 25, 2002, at Part 2, p. 1.

263. Craig D. Rose, *State Wants Out of Sempra Power Deal*, SAN DIEGO UNION-TRIBUNE, July 3, 2002, at C-1.

264. *Id.* In particular, the state faults Sempra's failure to finish building a 300-megawatt generating station in Bakersfield, California, by April 2002; instead, Sempra opted to resell electricity that it purchased from other generators. *Id.* California claims that Sempra did not seek its permission in choosing to purchase power; the state claims it needed the generating station in place for the summer of 2002. *Id.* California claims that the contract only allows failure to construct new power plants when Sempra unsuccessfully makes commercially reasonable efforts to finish a plant. *Id.*

265. *Id.* (Sempra claims that it will be spending over \$1 billion in order create more than 2,100 megawatts of new power generation in the West).

266. *Id.*

Without entering into a discussion of the merits of the dispute, in light of the current lawsuit in San Diego Superior Court, a successful claim of misrepresentation could allow California to rescind the Sempra power contract.²⁶⁷ Courts permit rescission where actual or constructive fraud occurs;²⁶⁸ all that is required is “a false representation of a material fact.”²⁶⁹ One misrepresentation, such as a promise to build new power plants, is enough to grant rescission.²⁷⁰ Here, California may be successful if it can prove that Sempra committed actual or constructive fraud to induce the state to enter into a contract as a result of a promise to construct additional power plants and use the resulting electricity to provide power to the state.²⁷¹

Alternatively, a person, including a corporation,²⁷² is in violation of the California False Claims Act (FCA) when it

- (1) Knowingly presents or causes to be presented to an officer or employee of the state or of any political subdivision thereof, a false claim for payment or approval[;]
- (2) Knowingly makes, uses, or causes to be made or used a false record or statement to get a false claim paid or approved by the state or by any political subdivision[;]
- (3) Conspires to defraud the state or any political subdivision by getting a false claim allowed or paid by the state or by any political subdivision[;]
- (4) Has possession, custody, or control of public property or money used or to be used by the state or by any political subdivision and knowingly delivers or causes to be delivered less property than the amount for which the person receives a certificate or receipt.²⁷³

A claim “includes any request or demand for money . . . made to . . . the state or of any political subdivision, . . . whether under contract or not, if any portion of the money . . . requested or demanded issued from, or was provided by, the state . . . or by any political subdivision thereof.”²⁷⁴ The requisite knowledge under the California FCA excludes specific intent to

267. CAL. CIV. CODE § 1689(b)(1) (Deering 2001) (“A party to a contract may rescind . . . [i]f the consent of the party rescinding . . . was . . . obtained through . . . fraud . . . exercised by or with the connivance of the party as to whom he rescinds. . .”).

268. *Lombardi v. Sinanides*, 235 P. 455, 457 (Cal. Ct. App. 1925); *Wilke v. Coinway, Inc.*, 64 Cal. Rptr. 845, 852 (Cal. Ct. App. 1967) (no need for party committing fraud to actually know of the veracity of the representation; rather, it should be an “assertion as a fact of that which is not true, by one who has no reasonable ground for believing it to be true”).

269. *Lombardi*, 235 P. at 457; *Wilke*, 64 Cal. Rptr. at 851.

270. *See id.* at 852.

271. *See Nancy Rivera Brooks, State Asks Judge to Void Sempra’s Electricity Contract*, L.A. TIMES, July 3, 2002, at Part 3, p. 2 (the DWR claims that it was misled by Sempra’s stated intent to construct extra power plants and provide California with the resulting power generated).

272. CAL. GOV. CODE § 12650(b)(5) (Deering 2001).

273. CAL. GOV. CODE § 12651(a)(1)–(4) (Deering 2001). The California FCA is based on the federal FCA. *Bury v. Cmty. Hosps.*, No. F036667, 2002 Cal. App. Unpub. LEXIS 1035, at *6 (Cal. Ct. App. May 8, 2002). In fact, at least one California court relied upon the federal FCA for guidance due to a “lack of California authority.” *City of Pomona v. Superior Court*, 107 Cal. Rptr. 2d 710, 716 (Cal. Ct. App. 2001).

274. CAL. GOV. CODE § 12650(b)(1) (Deering 2001).

commit fraud, but instead includes actual knowledge and acts in “deliberate ignorance” or “reckless disregard” of the veracity of the information supplied.²⁷⁵ Either the attorney general or a private individual can commence California FCA civil actions.²⁷⁶ Any person found in violation of the California FCA must pay treble damages to the state or political subdivision that is defrauded; additionally, violators may be responsible for the costs of litigation and a civil penalty up to \$10,000 per false claim.²⁷⁷ The remedies available under the California FCA are not exclusive.²⁷⁸

California courts broadly read cases arising under the California FCA.²⁷⁹ A violation of the California FCA can occur based upon a claim or “when a contract was originally obtained based on false information or fraudulent pricing.”²⁸⁰ Given this framework, depending on the facts that arise at trial, the state may be able to succeed under the California FCA if it can show fraud under the Sempra contract that subsequently led to Sempra’s requests to be paid under the contract. A key factor will be determining whether Sempra never intended to build additional power plants but nonetheless sought a contract with the state. Insofar as the other power purchase contracts are based in fraud, California may be able to litigate additional claims under the California FCA.

VII. What If There Is No Legal or Contractual Basis to Avoid Liability?

A. Liability

1. California

When faced with a breach of contract issue, courts treat the Federal Government much like a private party.²⁸¹ By analogy, California contract law provides guidance as to the proper remedy for damages in the event that the DWR or the state breaches a power purchase contract with a generator. Section 3281 of the California Civil Code recognizes the availability of damages for persons that are harmed by another party’s “unlawful act.”²⁸² Damages are defined as “the amount [that] will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.”²⁸³ Moreover, damages must

275. *Id.* § 12650(b)(2) (Deering 2001).

276. *Id.* § 12652 (Deering 2001).

277. *Id.* § 12651(a) (Deering 2001).

278. *Id.* § 12655 (Deering 2001).

279. *City of Pomona v. Superior Court*, 107 Cal. Rptr. 2d 710, 716 (Cal. Ct. App. 2001).

280. *Id.* at 717 (quoting *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 776, 787–88 (4th Cir. 1999)).

281. *Madden & Gold*, *supra* note 196.

282. CAL. CIV. CODE § 3281 (Deering 2001) (money damages allowed).

283. *Id.* § 3300 (Deering 2001).

be reasonable²⁸⁴ and cannot exceed what the nonbreaching party would have received for full performance.²⁸⁵ For readily ascertainable damages, interest on the monetary compensation owed to the nonbreaching party is also available.²⁸⁶

The California Civil Code provides that “the value of property to a seller . . . is deemed to be the price which he could have obtained therefore in the market nearest to the place at which it should have been accepted by the buyer, and at such time after the breach of the contract as would have sufficed, with reasonable diligence, for the seller to affect a resale.”²⁸⁷ This provision defines the rights of the seller (e.g., the generators) aggrieved by the buyer’s (i.e., California’s) nonperformance.²⁸⁸ The nonbreaching party can receive profits or benefits, shown with reasonable certainty, that would have accrued but for the breach.²⁸⁹ A party can demonstrate expected profits by a reasonable estimation of its magnitude had the party fully performed its contractual duties.²⁹⁰ Courts consider whether the sellers would have incurred a loss had the transaction occurred.²⁹¹ Therefore, the generators may be able to recover their profits from the long-term contracts if the state were held in breach under California contract law. The power purchase agreements’ durations can be used to ascertain how much the generators would have received had the contracts been fully performed.²⁹²

2. Federal Approach—A Comparison

If the Federal Government properly uses a termination for convenience clause, then the contractor (e.g., a contracting generator) will be entitled to compensation.²⁹³ A contractor can receive “actual allowable and allocable costs, including settlement expenses, that it can prove, plus profit on only the incurred costs.”²⁹⁴ Termination for convenience does not give a contrac-

284. *Id.* § 3359 (Deering 2001).

285. *Id.* § 3358 (Deering 2001).

286. *Id.* § 3287 (Deering 2001).

287. *Id.* § 3353 (Deering 2001).

288. See *Burner v. Am. Bar Quart Mining Co.*, 246 P. 74, 75 (Cal. Dist. Ct. App. Ct. 1926) [ok “Quart”? or s/b “Quartz?”] (holding that one remedy for the seller is to be compensated for the “difference between the contract price and the price obtained on a resale”).

289. *Dominium Mgmt. Servs., Inc. v. Nationwide Hous. Group*, 3 F. Supp. 2d 1054, 1062 (D. Minn. 1998) (quoting *Fisher v. Hampton*, 118 Cal. Rptr. 811, 814 (Cal. Ct. App. 1975)).

290. *Id.* at 1063 (quoting *Pac. Scientific Co. v. Glassey*, 54 Cal. Rptr. 235, 243 (Cal. Ct. App. 1966) (quoting *Nelson v. Riesner*, P.2d 17, 23–24 (Cal. 1958))).

291. *Id.*

292. *Cf. Stark v. Shaw*, 317 P.2d 182, 187–88 (Cal. Dist. Ct. App. Ct. 1957).

293. *Frederick Moring & Raymond F. Monroe, Selling Energy to the Federal Government; A Call for Sensible Procurement Rules*, PUB. UTILS. FORTNIGHTLY, Feb. 1, 1998, at 34 (application of federal procurement law to utilities providing energy to the Federal Government).

294. *Id.*

tor expectation or anticipatory damages, nor does it reimburse the contractor for all of its expenses.²⁹⁵ A successful breach action provides the plaintiff with expectation damages. A court may hold the Government in breach if it uses the termination for convenience clause despite knowing all along that it would not fulfill its obligations.²⁹⁶ Finally, if the Federal Government chooses to invoke a termination for convenience, the contractor will now lack a contract, either in whole or in part.²⁹⁷ If termination for convenience is not proper, then this is classified as a breach,²⁹⁸ with the potential for anticipatory damages being awarded to the contractor.²⁹⁹

B. Renegotiation

An alternative to winding up in court is for California to renegotiate the contracts so that their terms are more favorable to the state.³⁰⁰ By July 2002, the state had already renegotiated nine of the fifty-six contracts while it terminated a smaller contract due to nonperformance.³⁰¹ Renegotiation would help efforts to reimburse California's taxpayer-supported general fund; since January 2001, \$6 billion from this fund has been used to acquire electricity for California utility customers.³⁰² A revenue bond is necessary to reimburse the general fund, yet this has not been issued.³⁰³ As of late 2001, the CPUC did not approve a rate agreement necessary to authorize such a bond.³⁰⁴ The losses to its general fund are impacting California's budget.³⁰⁵

As a sovereign, California can offer the generators incentives to renegotiate the contracts. One journalist said that California has a strong bargaining chip to persuade the generators to renegotiate the long-term contracts: the CPUC can deny the approval of any revenue bond without new lower prices in the contracts.³⁰⁶ Thus, the contracts would have no value because Cali-

295. *Id.*

296. *Krygoski Constr. Co. v. United States*, 94 F.3d 1537, 1541–44 (Fed. Cir. 1996) (bad faith would be an improper termination for convenience).

297. *See id.* at 1543.

298. *Id.* at 1541.

299. *Krygoski Constr.*, 94 F.3d at 1545 (because of proper termination for convenience, no anticipatory profits granted); *cf. Kalvar Corp., Inc. v. United States*, 543 F.2d 1298, 1303–04 (Ct. Cl. 1976).

300. Vogel, *supra* note 102, at Part 2, p. 8; BUREAU OF STATE AUDITS, *supra* note 50, at 176.

301. Rose, *supra* note 24.

302. Ed Mendel, *California Power Chief Wants to Renegotiate Energy Pacts*, COPLEYS NEWS SERVICE, Nov. 27, 2001.

303. Martin & Gledhill, *supra* note 97, at A1.

304. Mendel, *supra* note 302 (the rate agreement was denied by the PUC for fears that state residents would be stuck with rates that were too expensive).

305. Walters, *supra* note 119. One estimate pegged California's budget deficit at \$14 million by late 2001, chiefly due to Governor Davis's efforts in the energy market, despite a \$6 billion surplus when his administration first took office. *Low Voltage Davis*, INVESTOR'S BUS. DAILY, Dec. 31, 2001, at A16.

306. *Id.*

ifornia is unable to pay for electricity without a bond.³⁰⁷ The state also may have leverage in renegotiating its contracts because of potential market manipulation by such energy companies as Enron.³⁰⁸

Freeman suggests that, due to California's creditworthiness, the state can act as a conduit for low-cost loans to the generators that are in the stages of erecting new power plants.³⁰⁹ The California Public Power Authority is capable of distributing up to \$5 million in revenue bonds to fund construction of power plants.³¹⁰ This is a crucial bargaining chip considering that the plants necessary to generate approximately 70 percent of the power implicated in over fifty of the contracts do not exist.³¹¹ The absence of a revenue bond hinders Freeman's hope to finance new projects,³¹² since concerns that the state will issue such a bond have lowered California's bond ratings in the eyes of credit-rating services.³¹³ When California receives low bond ratings, it has to pay additional amounts in interest for new loans.³¹⁴ In addition to renegotiation efforts, California is capable of requesting FERC to order generators to compensate the state for overpaying for electricity.³¹⁵ FERC may negate some contracts because of conflicts of interest if it turns out that the state employees involved in their bargaining acted unethically.³¹⁶

California may attempt to renegotiate the agreements in order to achieve "reliable reasonably priced electric service."³¹⁷ In particular, many have pointed to the high prices of the power in the long-term contracts as compared to the spot-market price.³¹⁸ The state's ratepayers will bear the net effect of this, thus providing another incentive for renegotiation.³¹⁹ Another focal point for these negotiations should be to ensure that the generators uphold their end of the agreements by continuing to provide existing power and fulfilling their promises to build additional generating facilities.³²⁰ The parties can renegotiate the terms within the contracts that vest the DWR with new termination remedies, including the clauses declaring an event of default,³²¹ canceling due to nonperformance,³²² or applying the standard "Termination

307. *Id.*

308. Brooks, *supra* note 24.

309. Mendel, *supra* note 302; *Undoing Costly Power Deals*, *supra* note 51, at 14.

310. *Undoing Costly Power Deals*, *supra* note 51, at 14.

311. Mendel, *supra* note 302.

312. *Id.*

313. Martin & Gledhill, *supra* note 97, at A1.

314. *Id.*

315. *Undoing Costly Power Deals*, *supra* note 51, at 14.

316. *Id.*

317. CAL. WATER CODE § 80000(a) (Deering 2001).

318. See Egan, *supra* note 97, at 1A29.

319. See Marois, *supra* note 52. The United States Justice Foundation lawsuit is based on a San Diego resident who alleges that his utility bills have gone up because of the long-term contracts.

320. See BUREAU OF STATE AUDITS, *supra* note 50, at 108-09.

321. *Id.*

322. *Id.* at 98-99.

for Cause” clause.³²³ Generators may have incentives to renegotiate because they could secure additional contracts with the state if another generator declares an event of default.³²⁴ In sum, renegotiation efforts could put the DWR and the generators on more equal terms.³²⁵

Whether the generators would assent to renegotiation is another issue. Williams was open to the possibility of renegotiation.³²⁶ On the other hand, Sempra Energy and Mirant Corporation have publicly said that they are not in favor of renegotiation.³²⁷ California, however, has supposedly begun to make efforts to renegotiate with the generators.³²⁸

VIII. Conclusion

The end of California’s energy crisis did not ameliorate the state’s woes in the energy market. What is clear is that the crisis has ended and things are different a year later. For example, PG&E Corp. encountered a \$951 million loss during the peak of the crisis in 2001; yet over the same time period in 2002, it had a \$631 million quarterly profit.³²⁹ Now, the state is faced with numerous long-term energy contracts that neither reflect California’s original objectives nor guarantee that the state will even receive all of the power that it originally specified in its contracts.

There is pressure to renegotiate the contracts, whose terms and prices both disfavor California. Even Governor Davis, who once hailed the contracts as the state’s solution to the crisis, recognizes the need to avoid the state’s current contractual obligations.³³⁰ California does not have the same termination rights as the generators, and the prices now look like a bad bargain. In fact, in February 2002, California requested that FERC exercise its authority over the allegedly unjust and unreasonable prices in thirty-two of the contracts, involving twenty-two energy companies.³³¹ Specifically, the state

323. See California Standard Contract Language, GTC 201, *supra* note 121 (term seven, “termination for cause”); California Standard Contract Language, GTC SF 201, *supra* note (term seven, “termination for cause”).

324. See BUREAU OF STATE AUDITS, *supra* note 50, at 101–02.

325. See *id.* at 3–5.

326. Marois & Ward, *supra* note 58; see also BUREAU OF STATE AUDITS, *supra* note 50 (analyzing California’s contracts with Williams).

327. Marois & Ward, *supra* note 58. Sempra Energy said in October 2001 that there was “no need for new talks” while Mirant Corporation supported the “sanctity of a contract.” *Id.*

328. *Id.* Both Calpine Corporation and Sempra Energy admitted that state officials brought up renegotiation with them. *Id.*

329. Dale Kasler, *Profits Soar at PG&E Corp.*, SACRAMENTO BEE, May 2, 2002, at D1. Part of PG&E’s profit is due to the fact that the California ISO cannot charge noncreditworthy companies for the sale of power. *Id.*

330. Jeff Adler, *California Asks to Void Energy Contracts; Long-Term Deals Carry High Prices*, WASH. POST, Feb. 26, 2002, at E04.

331. *Id.*

regulators argued that California overpaid the generators by \$21 billion.³³² The duration of the contracts magnifies the state's concerns, with some agreements in excess of ten years in length.³³³ Enron's difficulties only bolster the argument that generators are overcharging California for power.³³⁴

This Note explored the various options available to California for terminating its contractual obligations. California is limited in its ability to pass new legislation or terminate the power purchase agreements under their express terms. The state would fare marginally better if it could apply federal procurement statutes and regulations to its situation. Nonetheless, California has viable arguments under the doctrine of unconscionability (depending on how strongly a tribunal considers the foreseeability of the state's current predicament), and by allegations of fraud, through either the California FCA or private contract law. California fares worse under the doctrine of changed circumstances, due in part to the DWR's role in negotiating the original agreements.

California faces an uphill battle in its attempt to get out of these unfavorable power purchase contracts. FERC, in a decision granting a full evidentiary hearing on the legality of the contracts, stated that "parties who seek to overturn market-based contracts into which they voluntarily entered will bear a heavy burden."³³⁵ This is true notwithstanding the high prices in the contracts.³³⁶ In fact, FERC acknowledged its own precedent, as well as that of the Supreme Court and other judicial authorities, in appreciating the "sanctity of contracts."³³⁷ Nevertheless, Governor Davis stated his intention to bring the dispute to the courtroom if federal regulators do not step in, with state officials arguing that the contracts are illegal.³³⁸ Meanwhile, several of the energy companies have maintained the validity of the agreements.³³⁹ It is unknown whether California's situation will resolve itself by lawsuit, renegotiation, or federal intervention. Meanwhile, several of the energy companies have maintained the validity of the agreements.³⁴⁰ Inevitably, the decision, or indecision, the parties arrive at will impact California's economy and its taxpayers.

332. *Id.*

333. *Id.*

334. *Id.*

335. *Public Utilities Commission v. Sellers of Long Term Contracts to the California Department of Water Resources*, 99 F.E.R.C. ¶ 61,087 (2002). It is worth mentioning that Commissioner William L. Massey, in a dissent, argued in favor of a thorough examination of the contacts and asserted that the Federal Power Act found unjust and unreasonable contracts to be unlawful. *Id.*

336. Rose, *supra* note 24.

337. *Sellers of Long Term Contracts*, 99 F.E.R.C. at ¶ 61,087.

338. Reiterman, *supra* note 262.

339. *Id.*

340. *Id.*