THE "FRAUD, ABUSE, OR SIMILAR GROUNDS" EXCEPTION UNDER SECTION 601(c)(2) OF THE NGPA

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Section 601(b)(1)(A) of the Natural Gas Policy Act of 1978 (NGPA),[1] provides that any amount paid in a first sale of natural gas is deemed just and reasonable under sections 4 and 5 of the Natural Gas Act (NGA)[2] if (1) the amount paid does not exceed the applicable maximum lawful price established under title I of the NGPA or (2) the sale has been deregulated under subtitle B of title I of the NGPA and there is no applicable maximum lawful price. Section 601(c)(2) of the NGPA[3] guarantees recovery by an interstate pipeline of any amount paid with respect to a purchase of natural gas if the amount paid is deemed just and reasonable for purposes of sections 4 and 5 of the NGA and the recovery is not inconsistent with the incremental pricing rules under title II of the NGPA, "except to the extent the Commission determines that the amount paid was excessive due to fraud, abuse, or similar grounds."

The determination of what constitutes "fraud, abuse, or similar grounds" has been the subject of extensive litigation before the Commission. One group of litigants has contended that this exception to the guaranteed passthrough of purchase gas costs is broad enough to encompass imprudent purchasing practices by the pipelines. Others have contended that the exception is much narrower, requiring serious improprieties of a different type and nature than mere imprudence.

The Commission has developed a position which appears to be very close to a standard of imprudence. Although the Commission has consistently held that "fraud, abuse, or similar grounds" does not include imprudence,[4] it has also held that "the same type of actions of a pipeline can be imprudent or abusive."[5] The articulated difference between abusive conduct and imprudent conduct is as vague and subtle as the distinction between ordinary negligence and reckless disregard in tort law, and may even be so vague as to be virtually indistinguishable. Nevertheless, despite the difficulties of determining whether a particular course of action may be abusive or imprudent at the time the action is taken, a finding of abuse will result in denial of the pipeline's passthrough of gas costs to the extent they are excess due to abuse, and a finding of imprudence may result in denial of the pipeline's recovery of fixed costs (return on equity).[6]

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[1] 15 U.S.C. § 3431(b)(1)(A) (Supp. IV 1980).
[2] 15 U.S.C. §§ 717d & 717e (1976).
[3] 15 U.S.C. § 3431(c)(2) (Supp. IV 1980).
[4] *See, e.g.*, Columbia Gas Transportation Corp., Opinion No. 204, 26 FERC ¶ 61,034 at 61,099 (1984).
[5] Columbia Gas Transmission Corp., Docket Nos. TA82-1-21-001, *et al.*, 26 FERC ¶ 61,036 at 61,131 (1984).
[6] *Id.*

An analysis of the development of the Commission's position on the "fraud, abuse, or similar grounds" exception to the guaranteed passthrough of purchase gas costs will provide some guidance as to the types of conduct which may be found to be abuse or imprudent. Unfortunately, the analysis will also reveal that it may be difficult in some cases for an interstate pipeline to be certain that it is in compliance with the Commission's standards.

A. *The Legislative History on "Fraud, Abuse, or Similar Grounds"*

The legislative history of the NGPA provides little guidance as to what Congress meant by "fraud, abuse, or similar grounds." The Joint Explanatory Statement of the Committee on Conference simply states:

> The conference agreement guarantees that interstate pipelines may pass through costs of natural gas purchases if the price of the purchased natural gas does not exceed the ceiling price levels established under the legislation which are deemed "just and reasonable" for purposes of the Natural Gas Act in the previous section. The conferees do not intend to guarantee passthrough of costs of natural gas purchases in cases of fraud or abuse as determined by the Commission.[7]

The June 15, 1978 Committee Print representing the preliminary agreement by the conferees to the bill states their agreement "to include language in the joint statement of managers that makes clear there is no intention to override the inherent enforcement power of FERC to police fraud, abuse, etc."[8] and their intent to "assure that there is no indirect or 'back door' producer regulation by FERC."[9] The Commission cited this language from the June 15, 1978 Committee Print as support for its first line of decisions that abuse refers not to imprudence but to serious improprieties:

> However, the June 5, 1978 Committee Print representing the preliminary agreement by the Conferees states their agreement "to include language in the joint statement of managers that makes clear there is no intention to override the inherent enforcement power of FERC to police fraud, abuse, etc." It is significant that the Conferees were concerned with the Commission's enforcement power, rather than its general Section 4 and Section 5 ratemaking power. This is particularly significant since the Conferees expressed an intent to "assure that there is no indirect or 'back door' producer regulation by FERC." The continuing discussion in the Committee Print suggests that the Conferees intended to

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[7]*FERC Statutes and Regulations* ¶ 3101 at 3132.

[8]Committee on Interstate and Foreign Commerce, Committee Print No. 95-55, 95th Cong., 2d Sess. 19 (1978).

[9]*Id.* When Congress stated its intent to assure no "back door" producer regulation, it was not acting in a vacuum. "Back door" producer regulation had been instituted by the Federal Power Commission (FPC) with respect to small producers in FPC Order No. 428, 45 F.P.C. 454 (1971). In that order, the Commission established blanket certificate procedures for small producers under which the rates of small producers would no longer be directly regulated but would be subjected to indirect regulation through the review of purchase gas costs of the pipelines. The Supreme Court held that this type of indirect, "back door" regulation was a permissible means of regulating producer rates under the NGA in *FPC v. Texaco*, 417 U.S. 380 (1974). This "back door" regulation of producer rates through review of pipeline purchase gas costs was thus an available frame of reference for the statement by Congress that it intended to assure no "back door" regulation of producers under the NGPA.

provide this assurance through adoption of the new two-pronged just-and-reasonable standard of Section 601(b) and pass-through provision in Section 601(c). Thus, it would appear that Sections 601(b) and (c) were intended to function independently of the prudence standard because (i) the application of prudence standard involves an exercise of general Section 4 and Section 5 ratemaking power rather than enforcement power, and (ii) the imposition of the prudence standard would indirectly affect if not directly regulate producer activities.[10]

Having found that imprudence does not constitute "fraud, abuse, or similar grounds," the Commission reserved judgment on the question of what does constitute "fraud, abuse, or similar grounds," noting that the answer to that question "has both legal and factual aspects which will benefit from development through the hearing process."[11]

B. The Commission's Policy Statement on "Fraud, Abuse, or Similar Grounds"

The hearing process to which the development of a standard was entrusted generated numerous intervenors alleging that various gas purchasing practices and policies of interstate pipelines with respect to section 107 deregulated natural gas constituted "fraud, abuse, or similar grounds." The arguments, in general, were that "abuse" is broad enough to encompass imprudent purchasing practices and that the payment of prices in excess of market clearing prices[12] is imprudent, *per se.*

In an effort to provide guidance to the administrative law judges and to the litigants as to the allegations necessary for a complaint to establish a *prima facie* case of "fraud, abuse, or similar grounds," the Commission issued a policy statement[13] reiterating its conclusion that the fraud standard does not encompass imprudent business judgments. The Commission examined the available body of tort law on fraud and misrepresentation at length and concluded that it "intends to limit the consideration of the fraud standard to a consideration of whether the otherwise just and reasonable price paid by a pipeline is excessive due to a misrepresentation of any kind."[14] The Commission noted that the policy statement does not have the force and effect of law and that in particular cases, both the underlying policy and its application to specific facts can be challenged.[15]

The policy, which is codified at 18 C.F.R. § 2.300, is as follows:

(a) In order for the issue of fraud, as that term is used in section 601(c) of the NGPA, to be considered in a proceeding, an intervenor or intervenors must file a complaint alleging that:

(1) The interstate pipeline, any first seller who sells natural gas to the interstate pipeline, or both acting together, have made a fraudulent misrepresentation or concealment; and

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[10]Columbia Gas Transportation Corp., 15 FERC ¶ 61,104 at 61,227 (1981) (footnotes omitted).

[11]*Id.* at 61,228.

[12]The market clearing price has been defined as that price which, when added to transmission and distribution costs, results in a rate which is competitive with No. 6 fuel oil. *See* Columbia Gas Transportation Corp., Opinion No. 204, 26 FERC ¶ 61,034 at 61,097 (1984).

[13]47 Fed. Reg. 6253 (February 11, 1982), *FERC Statutes and Regulations* ¶ 30,336.

[14]*FERC Statutes and Regulations* ¶ 30,336 at 30,115.

[15]*Id.*

(2) Because of that fraudulent misrepresentation or concealment, the amount paid by the interstate pipeline to any first seller of natural gas was higher than it would have been absent the fraudulent conduct.

(b) In order for the issue of abuse, as that term is used in section 601(c) of the NGPA, to be considered in a proceeding, an intervenor or intervenors must file a complaint alleging that:

(1) The interstate pipeline, a first seller who sells to the interstate pipeline, or both acting together, have made a negligent misrepresentation or concealment, or other misrepresentation or concealment in disregard of a duty; and

(2) Because of that negligent misrepresentation or concealment, or other misrepresentation or concealment in disregard of a duty, the amount paid by the interstate pipeline to any first seller of natural gas was higher than it would have been absent the negligent misrepresentation or concealment, or other misrepresentation or concealment made in disregard of a duty.

(c) In order for the issue of similar ground, as that term is used in section 601(c) of the NGPA, to be considered in a proceeding, an intervenor or intervenors must file a complaint alleging that:

(1) The interstate pipeline, any first seller who sells natural gas to the interstate pipeline, or both acting together, have made an innocent misrepresentation of fact; and

(2) Because of that innocent misrepresentation of fact, the amount paid by the interstate pipeline to any first seller of natural gas was higher than it would have been absent the innocent misrepresentation of fact.

This statement of policy, as it relates to "abuse," was rapidly abandoned. Abuse quickly became something more closely akin to imprudence than to "a negligent misrepresentation or concealment" or "a misrepresentation or concealment in disregard of a duty."

C. *The CIG Decisioon*

The first "fraud, abuse, or similar grounds" case to be decided after issuance of the Commission's policy statement was *Colorado Interstate Gas Company.*[16] In that case, the State of Texas (Texas) argued that the section 107 derégulated gas costs of Colorado Interstate Gas Company (CIG) should be denied passthrough under section 601(c)(2) of the NGPA because (1) CIG was not properly managing its gas purchase program and that mismanagement constituted an abuse of discretion resulting in excessive gas prices; (2) CIG was abusing the pricing scheme and passthrough mechanisms of the NGPA by paying prices for deregulated natural gas in excess of the marginal market value of that gas; and (3) CIG was purchasing excessive amounts of deregulated gas at excessive prices, thereby abusing its managerial discretion.

The administrative law judge did not render a decision on the proper definition of "fraud, abuse, or similar grounds." The judge found that the evidence did not

[16] 19 FERC ¶ 63,003 (Initial Decision), *aff'd.*, 19 FERC ¶ 62,278 (1982).

support a finding of "fraud, abuse, or similar grounds" under either the definition set forth in the Commission's policy statement or the definition advanced by Texas that imprudent purchasing practices constitute an abuse. The judge held that the major flaw in the case presented by Texas was its failure to show that the claimed abusive practices had led to current prices which were excessive. None of the parties filed exceptions to the initial decision, and the Commission took no action to initiate review. The initial decision thus became final pursuant to Rule 713 of the Commission's Rules of Practice and Procedure.[17]

D. The Tennessee Decision

The Commission's hearing order in *Tennessee Gas Pipeline Company (Tennessee)*[18] and the *Tennessee* line of cases[19] represent the Commission's last attempt to separate imprudence from "fraud, abuse, or similar grounds." In *Tennessee,* the Commission held that prudent purchasing practices are different from "fraud, abuse, or similar grounds" and should be considered in a general rate proceeding under section 4 or 5 of the NGA and not in a PGA proceeding concerning the passthrough of purchase gas costs.

In the *Tennessee* order, the Commission also gave notice that it would consider the use of the pipeline's rate design as a means of protecting consumers from the consequences of imprudent gas purchasing practices. The pipeline's rates would be designed in such a way that recovery of fixed costs and full, allowed return on equity would be contingent upon the pipeline's success in avoiding load loss. This would be accomplished by adjusting the sales volumes on which the pipeline's rates are based to include phantom volumes which would have been sold if the pipeline had employed prudent gas purchasing practices. The Commission did not elaborate on how it would determine the volumes the pipeline would have sold had it engaged in prudent purchasing practices, and, more importantly, did not provide clear and adequate guidelines as to the types of purchasing practices which would cause the Commission to impute phantom sales volumes to the pipeline. Absent clear and adequate guidelines as to the types of actions which will result in the sales volume remedy, the pipeline has no reasonable means of determining what it must do to insure full cost recovery. This is an impermissible regulatory result.[20]

The Commission analogized its use of rate design as a means of encouraging prudent gas purchasing practices to the actions of the Civil Aeronautics Board (CAB) with respect to airline fares. In the early 1970's, the airlines' fares were fixed by the CAB, and the airlines thus competed for customers on the basis of non-price terms such as frequency of flights. As a result, load factors decreased. In order to shift the risk of underutilization of the airlines from consumers to shareholders, the CAB established industry-wide load factors in the design of airline rates.[21]

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[17] 18 C.F.R. § 385.713(a)(3).

[18] 21 FERC ¶ 61,004 (1982).

[19] *See, e.g.,* Cities Service Gas Co., 21 FERC ¶ 61,282 (1982); United Gas Pipe Line Co., 19 FERC ¶ 61,346 (1982).

[20] *See* FPC v. Texaco Inc., 417 U.S. 380 (1974).

[21] *See* Moss v. CAB, 521 F.2d 298 (D.C. Cir. 1975), *cert. denied sub nom.,* Roberts v. CAB, 424 U.S. 966, *reh. denied,* 425 U.S. 966 (1976).

An important distinction between the airlines' non-price competition and the pipelines' gas purchasing practices was overlooked by the Commission. While airlines can cancel flights, move equipment to other routes, or even dispose of excess equipment by sale, it is not so easy for interstate pipelines to cancel or modify the terms of existing gas purchase contracts, change their obligations to serve their customers, or move, sell, or dispose of their "equipment." The imputation of phantom sales volumes to pipelines may thus prevent recovery of the pipeline's fixed costs (return on equity) and yet provide no real opportunity for the pipeline to correct the imprudent purchasing practice and recover its fixed costs (return on equity). The more useful remedy would be for the Commission to order the pipelines to observe those purchasing practices which the Commission deems prudent in prospective purchases of natural gas and to order the modification of existing contractual terms on a prospective basis. Such orders under section 5 of the NGA would support the pipelines' exercise of *force majeure* clauses or "FERC-out" clauses in their gas purchase contracts and ensure that gas would be purchased in accordance with practices which the Commission deems prudent. Despite the obvious benefits of such orders, the Commission has not yet attempted to employ this type of remedy.

E. *The Columbia Decision*

A little more than one year after the *Tennessee* order was issued, the Commission abandoned the definition of abuse set forth in the policy statement on "fraud, abuse, or similar grounds." In *Columbia Gas Transmission Corporation (Columbia)*,[22] the Commission held that a pipeline's gas acquisition and cutback policies and practices constitute an abuse to the extent that they (1) evidence reckless disregard of the pipeline's fundamental duty to provide service at the lowest, reasonable rate consistent with maintenance of adequate service and (2) have a significant adverse effect on customers or consumers.[23]

Action evidencing reckless disregard of a duty was defined as "action taken in disregard of a risk that was known or was so obvious it must be taken to have been known and that was so great as to make it highly probable that an adverse effect would follow from such action."[24] The Commission did not attempt to define all significant adverse effects of reckless disregard, but did note that increased gas costs and load loss were two such possible adverse effects.[25] The Commission went on to note that passthrough is denied "only if and to the extent that abusive conduct actually causes the amount paid for gas to be 'excessive.'"[26]

Although the Commission maintains that its new definition of abuse is not equivalent to imprudence,[27] the distinction between the two standards is as vague and subtle as is the distinction between ordinary negligence and reckless disregard

[22]Opinion No. 204, 26 FERC ¶ 61,034 (1984), *reh. granted in part*, Opinion No. 204-A, 26 FERC ¶ 61,334. The Commission did not change the policy statement definitions of "fraud" and "similar grounds."

[23]Opinion No. 204-A, 26 FERC ¶ 61,334 at 61,710 (1984).

[24]*Id.* at 61,712.

[25]*Id.* at 61,713.

[26]*Id.*

[27]*Id.* at 61,711-12.

in tort law. One of the comments to section 282 of the *Restatement (Second) of Torts* notes the difficulty of drawing the line between negligence (imprudence) and reckless disregard, and describes the distinction between the two as follows:

> The word "negligence" excludes conduct which the actor does or should realize as involving a risk to others which is not merely in excess of its utility, but which is out of all proportion thereto and is therefore "recklessly disregardful of the interests of others." As the disproportion between risk and utility increases, there enters into the actor's conduct a degree of culpability which approaches and finally becomes indistinguishable from that which is shown by conduct intended to invade similar interests. Therefore, where this disproportion is great, there is a marked tendency to give the conduct a legal effect closely analogous to that given conduct which is intended to cause the resulting harm.[28]

Thus, reckless disregard approaches, but is different from, an intent to cause harm. It involves a "risk of harm to others substantially in excess of that necessary to make the conduct [imprudent]."[29]

The close relationship between the Commission's standards for abuse and imprudence are demonstrated by the types of action found to be imprudent or in reckless disregard of the pipeline's duty in the *Columbia* decision. As the Commission has acknowledged, it now believes that "the same type of actions of a pipeline can be imprudent or abusive."[30]

1. *Contractual Provisions*

In the *Columbia* decision, the Commission looked at the prices Columbia was paying for deregulated section 107 gas and the terms of the contracts for the purchase of that gas which included (i) high (85-90 percent) take-or-pay clauses, (ii) indefinite price escalator clauses tied to the price of No. 2 fuel oil, (iii) favored nations clauses, and (iv) market-out clauses which do not become operative until 1985.

The Commission found no reckless disregard on the part of Columbia because there was no evidence that Columbia had paid more for section 107 gas or had agreed to more stringent contractual provisions than was required by competitive market conditions at the time the contracts were negotiated. The Commission also concluded that Columbia did not act with reckless disregard when it paid more than the market clearing price[31] for section 107 gas in light of Commission policy permitting rolled-in-pricing.

The Commission did find, however, that the take-or-pay provisions of Columbia's contracts are now unjust, unreasonable, unduly discriminatory and preferential even though those provisions were reasonable at the time they were negotiated:

> While the take-or-pay provisions were not unreasonable when entered into, the effect of these provisions under present conditions is unjust, unreasonable, unduly discriminatory

[28]Restatement (Second) of Torts § 282, Comment e (1965).
[29]Restatement (Second) of Torts § 500, Comment a (1965).
[30]Columbia Gas Transmission Corp., Docket Nos. TA82-1-21-001, *et al.*, 26 FERC ¶ 61,036 (1984). This is contrary to the position stated in *Tennessee*.
[31]*See* note 12 *supra*.

> and preferential. It is harmful to Columbia's customers who stand to lose markets because of fuel switching and unfair to consumers who must bear the cost. It is discriminatory to low-cost gas producers whose production is cut back. It is potentially harmful to Columbia itself.[32]

The Commission ordered Columbia "to take all reasonable action to mitigate the adverse consequences of its take-or-pay contract provisions"[33] and to report the actions taken to the Commission each quarter until January 1985.

Interestingly, the Commission did not find the take-or-pay or other contract provisions to be "imprudent." This was proper because prudence must be judged only from the circumstances existing at the time the action is taken. As one of the comments to section 282 of the *Restatement (Second) of Torts* provides:

> In determining whether the actor should recognize the risks which are involved in his conduct, either of act or omission, only those circumstances which the actor perceives or should perceive at the time of his action or inaction are to be considered. Circumstances which occur after the conduct which is alleged to be negligent are as immaterial as are those circumstances which exist at the time of his action or inaction, but of which the actor neither knows nor should know, although known to third persons.[34]

The Commission has consistently followed this rule when applying the prudence standard to natural gas pipelines.[35]

Absent imprudence at the time the take-or-pay provisions were negotiated, there were no imprudently incurred costs, and the Commission was correct in not attempting to deny recovery of costs either directly or indirectly through rate design. However, the remedy which the Commission did select for redressing Columbia's "unjust and unreasonable" contractual provisions is too vague to be of any real use in correcting the problem. The Commission ordered Columbia "to take all reasonable action to mitigate the adverse consequences" of the contractual provisions, but gave no clues as to what it considered "all reasonable action." Columbia and others[36] have asked the Commission to rule on the reasonableness of certain gas purchase practices and contractual modifications which they have implemented to deal with unreasonable contractual provisions, but the Commission has not been willing to act on those requests. Consequently, there is no indication as to whether actions like the Emergency Gas Purchase Policy of Tennessee Gas Pipeline Company are "all reasonable action," or whether some other type of action is required. Absent clear guidelines as to what constitutes "all reasonable action," the

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[32]Opinion No. 204, 26 FERC at 61,120.

[33]*Id.*

[34]Restatement (Second) of Torts § 282, Comment h (1965).

[35]*See, e.g.*, Metzenbaum v. Columbia Gas Transmission Corp., Opinion No. 25, 4 FERC ¶ 61,277 at 61,620 (1978), *reh. denied*, 5 FERC ¶ 61,095 (1978) ("the judgment must be one which a reasonable man acting in good faith might have made under the circumstances then known and within the time which appeared available for action"); El Paso Natural Gas Co., 57 F.P.C. 989, 998 (1977) (in determining prudence, the primary issue is "whether El Paso acted reasonably and prudently, in light of the circumstances existing at the time").

[36]See, the complaints and requests for declaratory order of Tennessee Gas Pipeline Company in Docket No. RP83-109 and Columbia Gas Transmission Corporation in Docket No. CI83-3-4-000.

Commission is essentially powerless to take any action against the pipeline for violating its directive, and the pipeline is exposed to substantial litigative risk in taking effective action to modify the "unjust and unreasonable" provisions of its gas purchase contracts. A definitive order directing that the "unjust and unreasonable" provisions of the gas purchase contracts are unlawful and of no force and effect would be more useful to both Commission and pipeline for ensuring the elimination of the "unjust and unreasonable" provisions.

2. *Gas Acquisition Practices*

The Commission found that Columbia acted with reckless disregard for its duty to provide service at the lowest reasonable rate in selecting No. 2 fuel oil rather than No. 6 residual oil as the competitive alternative fuel on its system and in ignoring the effect of competition from No. 6 fuel oil in determining how much gas to purchase at a given price. This reckless disregard was not considered an abuse under section 601(c)(2) of the NGPA because it did not have a significant, adverse effect on Columbia's customers during the relevant PGA periods. The Commission found that Columbia's customers did not suffer a significant loss of markets to No. 6 fuel oil during the PGA periods involved, and that the marketing problems that did occur were attributable to an economic recession and decline in residual fuel oil prices which could not reasonably have been foreseen by Columbia when it contracted for the section 107 deregulated gas.[37]

Interestingly, in its determination that Columbia acted with reckless disregard, the Commission did not discuss whether other pipelines followed the Columbia purchasing strategy. This differs from its resolution of the contractual provisions issue where the Commission found:

> Reckless conduct is action taken in disregard of a risk so obvious that it must be taken as known and so great that harm is highly probable. The parties have not shown why, if the risk of harm from purchasing Section 107 gas at the terms generally demanded by producers was so obvious, they cannot demonstrate that other pipelines recognized that risk.[38]

If Columbia had shown that other pipelines had followed the same purchasing strategy as Columbia, they might have avoided the finding of reckless disregard.

Having found that Columbia's gas acquisition practices constituted reckless disregard, the Commission went on to find that those practices also violated the less stringent requirement of just and reasonable practices under the NGA and that the practices were, in fact, "imprudent and unjust and unreasonable under NGA section 5."[39] The Commission found that the only necessary remedy for Columbia's imprudent gas acquisition practices was the adoption of a rate case settlement which set the sales volumes underlying Columbia's rates at a level that reflects prudent gas acquisition practices. The Commission stated, "To the extent Columbia fails to

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[37]Opinion No. 204, 26 FERC at 61,101-03.
[38]Opinion No. 204-A, 26 FERC at 61,716.
[39]Opinion No. 204, 26 FERC at 61,112.

achieve the sales volumes on which its rates are predicated, its recovery of fixed costs is reduced, with any reduction in such recovery coming out of return on equity."[40]

The establishment of sales volumes as the remedy for imprudent gas acquisition practices is not particularly troublesome in the *Columbia* case because it was part of a settlement agreed to by Columbia. However, the establishment of sales volumes as a general remedy for imprudent purchasing practices is, as previously discussed,[41] unsatisfactory due to the absence of satisfactory guidelines for determining whether a particular action will result in the establishment of phantom sales volumes and the denial of fixed cost recovery (return on equity). It would be more appropriate for the Commission to determine the contracting practices which are "to be thereafter observed and in force," consistent with section 5 of the NGA.[42]

3. *Cutback Practices*

In *Columbia,* the Commission also found that neither the "fraud, abuse, or similar grounds" standard nor the prudence standard requires that gas supplies be cutback on a least cost, price-only, basis. A general policy to "cut back first on the highest price supplies, consistent with operational limitations, provided that no gas is cut to below take-or-pay levels"[43] is permissible.

4. *Purchasing Agents*

Although believed to be a "close question," the Commission found insufficient evidence to warrant a finding that Columbia's use of its affiliated supplier, Columbia Gas Development Corporation (CGD), as its purchasing agent for southwestern supplies constituted reckless disregard. Even if the use of a purchasing agent had been found to constitute reckless disregard, there was no abuse within the meaning of section 601(c)(2) of the NGPA because the use of the purchasing agent did not result in increased gas costs.

The Commission did find that there was an inherent conflict between CGD's interest, as Columbia's supplier, in maximizing its sales profit and CGD's interest, as Columbia's purchasing agent, in minimizing Columbia's purchase gas costs. It therefore found the use of CGD as a purchasing agent to be "imprudent, unjust, and unreasonable"[44] and ordered Columbia to phase out its use of CGD as purchasing agent over a one-year period.

F. Subsequent Columbia Hearing Orders

After the issuance of Opinion No. 204, the Commission acknowledged the relatedness of its "fraud, abuse, or similar grounds" standard and its prudence standard in an order consolidating the remaining Columbia PGA cases with

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[40]*Id.*
[41]*See* pp. 10-11 *supra.*
[42]15 U.S.C. § 717e (1976).
[43]Opinion No. 204-A, 26 FERC at 61,720.
[44]Opinion No. 204, 26 FERC at 61,116.

Columbia's ongoing section 4 rate case.[45] In that order, the Commission set the issues of "fraud, abuse, or similar grounds" and imprudence for hearing in a consolidated proceeding and, in so doing, reversed the *Tennessee* case and the *Tennessee* line of cases. In support of its position, the Commission stated:

> In resolving the abuse and imprudence issues in the Columbia case, it became evident that imprudence and abuse are distinguishable but closely related, that the same type of actions of a pipeline can be imprudent or abusive, and that the same evidence can be relevant in determining whether actions were imprudent or abusive. Consequently, it is no longer desirable or efficient to resolve the merits of allegations of imprudence and abuse in separate proceedings in all instances.... We conclude that the merits of both prudence and fraud or abuse issues raised by parties concerning a given PGA filing should, in general, be considered in the PGA proceeding, and the prudence issues should not be reserved for a section 4 or 5 general rate proceeding with the exceptions noted below [when general rate proceeding remedies are deemed necessary].[46]

G. *Implications for Pipeline Purchasing Practices*

The foregoing discussion indicates that the Commission has established an abuse standard that is so closely related to the NGA prudence standard that the two may be indistinguishable. Although it is unlikely that this is the result intended by Congress,[47] it is the result against which the pipeline must guard its actions, for a finding of abuse will lead to denial of recovery of gas costs and a finding of imprudence may lead to a denial of recovery of fixed costs.

Accordingly, in order to avoid actions that may be held abusive or imprudent, it is desirable to examine the Commission's orders for guidance as to the types of action that are permissible under both standards. Unfortunately, the guidelines with respect to permissible conduct are so vague in certain instances that it may be difficult for an interstate pipeline to be certain that the action it proposes to take is in compliance with the standards.

This vagueness with respect to the guidelines for compliance with the Commission's abuse and imprudence standards appears to be impermissible under the United States Supreme Court's decision in *FPC v. Texaco Inc.*[48] In that case, the Court reviewed FPC Order No. 428[49] which established blanket certificate procedures for small producers. Under the blanket procedures, the rates of small producers were regulated indirectly through the review of purchase gas costs of pipelines. If the price which the pipeline paid the small producer was found to be unreasonable, the pipeline was required to make refunds to its customers, but the small producer was not required to make refunds to the pipeline. This "pipeline squeeze," which is closely analogous to the squeeze placed on the pipelines by the Commission's proposed denial of fixed cost recovery in the case of imprudent purchasing practices, was said to be impermissible if inadequate guidelines were

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[45]Columbia Gas Transmission Corp., Docket Nos. TA82-1-21-001, *et al.*, 26 FERC ¶ 61,036 (1984).

[46]*Id.* at 61,131.

[47]The Commission itself has found that Congress did not intend abuse to be equivalent to imprudence. *See* Opinion No. 204, 26 FERC at 61,099.

[48]417 U.S. 380 (1974).

[49]45 F.P.C. 454 (1971).

given as to the standards by which the pipeline's purchase gas costs would be reviewed for unreasonableness. The Court directed that "additional attention be given this question in the course of the remand proceedings"[50] on Order No. 428.

1. *Price and Contractual Terms*

To avoid a finding of abuse or imprudence with respect to the price paid or the terms offered for the purchase of section 107 deregulated gas, the *Columbia* decision indicates that a pipeline should pay no more for the gas and should agree to no less favorable contract terms than required by competitive market conditions.[51] There is no indication as to the number of more favorable contracts required to support a finding of abuse or imprudence. It is not clear whether the existence of one more favorable contract will result in a finding of abuse or imprudence or whether a larger number of more favorable contracts is required.

The practical problem for the purchaser attempting to comply with the Commission's standard is the determination at the time of contract negotiation of whether other purchasers are paying less or receiving more favorable contract terms for comparable purchases. Such information is highly confidential and not readily available to the prospective purchaser. The Commission has inquired, in its Notice of Inquiry in Docket No. RM84-12,[52] whether pipelines should be required to include information concerning their gas purchase contracts in their PGA filings. The inclusion of this type of information in the PGA filings could be of some help to purchasers attempting to pay comparable prices and negotiate comparable terms, but the information would not necessarily be current at the time the new purchase is being negotiated due to the timing of PGA filings. Absent blatant violation of the antitrust laws with all purchasers agreeing to offer the same prices and terms for comparable purchases, it is difficult to see how any purchaser could ever be certain that other purchasers haven't negotiated more favorable prices or contract terms. Such conduct in violation of the antitrust laws is, of course, an unacceptable means of complying with the Commission's abuse and imprudence standards.

A more acceptable strategy for complying with the requirement that the purchaser pay no more and agree to no less favorable contract terms than required by competitive market conditions, is to offer conservative prices and contract terms and increase those offers only after rejection by the seller. The fact that Columbia made offers for purchase which were rejected as inadequate before it offered more favorable terms to its producers weighed heavily in the Commission's decision that Columbia paid no more than the competition required.[53]

Generally, the contract provisions which are most likely to be challenged as abusive or imprudent are (1) high take-or-pay clauses (85% and above);[54] (2)

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[50]417 U.S. at 393.

[51]Opinion No. 204, 26 FERC at 61,714-16.

[52]"Revisions to the PGA Regulations," Notice of Inquiry issued April 27, 1984 in Docket No. RM84-12-000, 49 Fed. Reg. 18539 (May 1, 1984).

[53]Opinion No. 204-A, 26 FERC at 61,714-16.

[54]Seventy-five percent with respect to gas purchase contracts entered into on or after December 23, 1982. *See* 18 C.F.R. § 2.103.

indefinite price escalator clauses tied to the price of No. 2 fuel oil; (3) favored nations clauses; and (4) market-out clauses which are not immediately operative. A purchaser would be well-advised to eliminate these provisions from future contracts, if competition permits the elimination.

Aside from comparability with other purchases, prices paid for deregulated section 107 gas have been challenged as abusive and imprudent if they exceed market clearing prices.[55] The Commission has ruled that individual contract prices may exceed market clearing levels due to the Commission's policy on rolled-in pricing,[56] but the pipeline must be able to demonstrate the future marketability of current gas acquisitions under rolled-in pricing conditions.[57]

2. *Gas Acquisition Practices*

In determining the amount of gas to purchase at a particular price, the pipeline should determine the alternative competitive fuel on its system and consider the effect of competition from that alternative fuel on the future marketability of the gas it purchases at a particular price.[58] Failure to follow this practice has been found to endanger the future marketability of current gas acquisitions and to constitute reckless disregard of the pipeline's duty to provide service at the lowest reasonable rate.[59]

The pipeline should select as its competitive alternative fuel the lowest-cost alternative fuel that competes for a significant portion of the pipeline's market. In *Columbia,* the 8.5 percent of Columbia's industrial market with which No. 6 fuel oil was in competition was found to be a significant portion of the market, and No. 6 rather than No. 2 fuel oil was accordingly found to be the appropriate competitive fuel.[60]

3. *Cutback Policies*

Once a pipeline determines that the supplies of natural gas available under its gas purchase contracts exceed the demand for gas on its system, it is prudent for the pipeline to cutback first on the highest price supplies, consistent with operational limitations, provided that no gas is cutback to below take-or-pay levels.[61] The pipeline is not required to institute a least-cost, price-only cutback policy as long as operational considerations such as (1) drainage, (2) requirements of oil production with respect to takes of casinghead gas, (3) contractual and physical ability to make up gas not taken, and (4) takes necessitated by exchange and transportation arrangements, limit the pipeline's ability to make price-based cutbacks.

The Commission has provided no guidelines with respect to cutbacks below take-or-pay levels. When the market demand takes the pipeline below take-or-pay

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[55]*See* note 12 *supra.*

[56]Opinion No. 204-A, 26 FERC at 61,714.

[57]Opinion No. 204, 26 FERC at 61,101-03.

[58]As gas-for-gas competition increases, it might be advisable for the pipeline to consider natural gas from other supply sources as the alternative competitive fuel on its system.

[59]Opinion No. 204, 26 FERC at 61,101-03.

[60]*Id.*

[61]*Id.* at 61,103-11.

levels, the pipeline is presented with the dilemma of taking lower cost gas now and incurring higher prepayment balances or taking higher cost gas now and incurring lower prepayment balances. This price dilemma must be factored in with operational considerations such as drainage and make-up rights before the cutback decision is made. Despite the difficulties of selecting the appropriate cutback policy in the case of cuts below take-or-pay levels, the Commission has provided no guidelines as to the prudent course of action.

H. Conclusion

As the foregoing discussion demonstrates, the Commission has indicated through its decisions on abuse and imprudence that it will take an active role in indirectly regulating the terms and conditions under which gas is purchased at the wellhead through regulation of the purchasing pipeline's rates. Such indirect regulation through the pipeline's rates is permissible only if the Commission provides adequate guidelines as to the types of action which will result in adverse rate consequences to the pipelines and is desirable only if the remedy selected ensures that prudent purchasing practices will be observed. The existing decisions of the Commission provide inadequate guidelines as to the types of conduct that will result in adverse rate consequences to the pipelines, and do not impose the types of remedies, such as prospective modification of contractual terms, which will ensure that prudent purchasing practices are observed.