INDEFINITE ESCALATORS: 1985
DOES FERC HAVE A "STAIRWAY" DOWN?

*J. David Hughes**

The following article does not represent an official position or statement of policy by the Federal Energy Regulatory Commission (FERC) or a public statement of a Commissioner in an official capacity, but is merely an individual exposition and legal analysis of a particular subject.

Considerable focus and attention have been given to natural gas contract provisions, serving as one of the large themes for intense debate during hearings conducted this year before the House Energy and Commerce Subcommittee on Fossil and Synthetic Fuels as well as the Senate Energy and Natural Resources Committee in the 98th Congress. In anticipation of partial decontrol currently scheduled under the Natural Gas Policy Act of 1978 (NGPA)[1] in 1985, mounting concern has been expressed over certain contract clauses and their projected effect. Particular focus is on contract provisions commonly referred to as "indefinite escalators," or "most favored nation clauses."[2] The impact of these clauses on interstate natural gas scheduled for decontrol in 1985 in today's economic environment of excess gas deliverability has been estimated to involve 87 percent of the gas subject to contracts containing deregulation clauses, of which 85 percent of such contracts contain "most favored nation" clauses that would be triggered by oil parity contracts.[3] No economic forecast is made that these clauses will result in higher prices for consumers of natural gas. This Article is a review of the history and an analysis of the legal efficacy and power of the Federal Energy Regulatory Commission (FERC) to curtail or modify the operation of such clauses in natural gas contracts between producers and pipelines in the absence of legislation to amend the NGPA before 1985.

*B.B.A., University of Texas; J.D., The Washington College of Law, American University; Member, Bar of Texas; Commissioner, Federal Energy Regulatory Commission, Washington, D.C.

[1]Pub. L. 95-621 (November 9, 1978), 15 U.S.C. § 3301 *et seq.*

[2]*Periodic escalation clauses* generally provide that the price currently paid under the contract shall be increased by specific amounts at certain definite future dates. Under a *two-party favored nation clause,* the pipeline agrees to pay a higher rate to a producer with whom it has a gas purchase contract in a given geographical area if the pipeline should purchase contract gas at a price higher from another producer in the same area. Under a *third-party favored nation clause,* the pipeline agrees to pay its suppliers from a certain field or area the highest price paid by any other pipeline to producers in the same field or area. *Redetermination clauses* generally provide that the price currently paid under the contract shall be subject to upward adjustment at certain specified times to reflect the average of the highest prices then paid by buyers to other suppliers for gas delivered under substantially similar terms and conditions. Other similar type clauses include commodity index adjustment clauses, renegotiation, spiral escalation, rate tracking or area rate clauses. 4 H. Williams & C. Meyers, Manual of Oil and Gas Terms, 196-97 (1976). The NGPA defines an *indefinite price escalator clause* as one that adjusts the contract price by reference to other prices for natural gas, crude oil, or refined petroleum products, or adjusts the price by negotiation between the parties. NGPA § 105(b)(3)(B), 15 U.S.C.A. § 3315(b)(3)(B), (Supp. 1978).

[3]U.S. Department of Energy, Energy Information Administration, Natural Gas Producer/Purchaser Contracts and Their Potential Impact on the Natural Gas Market, and Analysis of the Natural Gas Policy Act and Several Alternatives, Part II, June 1982, 39-41.

Indefinite Escalators: The FPC and the Natural Gas Act

The Federal Power Commission (FPC), following the *Phillips* decision by the Supreme Court in 1954,[4] restricted the use of indefinite pricing clauses through a series of decisions under the authority of the Natural Gas Act (NGA). The lead case, Pure Oil Company,[5] involved an attempt by an independent producer to charge an escalated rate for natural gas from the Permian Basin based on a sale to El Paso Natural Gas Company under three separate contracts at a lower rate. The Commission refused to permit the increased rates on the ground that the two-party, favored nation clause was not triggered through a sale by El Paso to another producer in the same geographical area at a higher contractual rate. The favored nation clauses contained provisions for gas having exceptional qualities, differentiating it from the price paid for gas of lesser quality under another contract. The FPC announced that it would prospectively disallow clauses of this nature, although the clauses were not considered to be activated in this case because of the difference in quality of the gas.[6]

In Order No. 242, the Commission, as previously promised, struck down a favored nation clause, along with a periodic fixed price clause, as contrary to the public interest and violative of Commission Regulations.[7] On review, the Court affirmed the order.[8]

The basis for the decision was that the increase in the contract price was by reference to events that had no economic significance to the particular sale of gas; *i.e.*, the price one producer received had no bearing on another's revenue needs or costs of production. Thus, the FPC, by invalidating the most favored nation clauses used traditional cost-based methodology employed for its utility rate review for producer rate regulation.[9] The cost-based rationale underlying these FPC decisions in sharp contrast with an incentive-based approach to rate setting for gas production, the underlying premise of the NGPA.

Indefinite Pricing Clauses: FERC and the NGPA

With the enactment of the NGPA on November 9, 1978, Congress determined the basic price ceilings in the statute itself. In general, the price ceilings set by the NGPA are higher than those established under the NGA, and in some categories they are drastically higher than the prices previously allowed under the NGA.

The FERC's first pronouncement in regard to the impact of the NGPA on indefinite pricing provisions in gas contracts was in its Interim Regulations. Literally stated, they provided that "The establishment of maximum lawful prices under the NGPA shall not trigger indefinite price escalator clauses in existing intrastate or

[4] Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, 74 S. Ct. 672 (1954); 15 U.S.C. § 717 *et seq.*

[5] Pure Oil Company, 25 FPC 383 (1961), *reh. denied* 25 F.P.C. 774 (1961), *aff'd* Pure Oil Company v. Federal Power Commission, 299 F.2d 370 (7th Cir. 1962).

[6] Pure Oil Company, supra, 388.

[7] Order No. 242, 27 FPC 339, promulgating 18 C.F.R. [Cum. Supp. 1963] § 154.93, entitled "Rate schedule defined," provides in part: "Provided, that in contracts executed on or after April 3, 1962, for the sale or transportation of natural gas subject to the jurisdiction of the Commission, any provision for a change of price (other than certain exemptions) shall be inoperative and of no effect at law."

[8] Superior Oil Company v. Federal Power Commission, 322 F.2d 601 (9th Cir. 1963) *cert. denied,* 377 U.S. 922, 84 S. Ct. 1219 (1964); Federal Power Commission v. Texaco, 377 U.S. 33, 84 S. Ct. 1105 (1964); Pan Am. Petroleum Corp. v. FPC, 352 F.2d 241 (10th Cir. 1965).

[9] Area rate proceedings followed the same reasoning. See In Re Permian Basin Area Rate Cases, 390 U.S. 747, 782-83, 88 S. Ct. 1344, 1367-1368 (1968).

interstate contracts."[10] Thereafter, a policy statement was issued on Area Rates,[11] and in Order No. 23, issued March 13, 1979,[12] the FERC said: "When interpreting indefinite escalators in existing interstate contracts, the Commission will give effect to the intention of the parties."[13] The Commission felt that there was insufficient evidence of Congressional intent to clearly prohibit such clauses, so the doubt was resolved in favor of no statutory bar. The Commission nevertheless asserted that the previous FPC regulations, 18 C.F.R. § 154.93, still prohibited indefinite price escalation clauses, "which it was specifically intended to prohibit, such as favored nation, redetermination, or spiral escalation clauses",[14] but the Commission further recognized in Order No. 23 that its authority to interpret contracts under the NGA terminated when the gas involved finally qualified for a price ceiling under NGPA sections 102(c), 103 or 107(c)(1)(4) and made rate schedule filings unnecessary.[15] The Commission reaffirmed its jurisdiction over indefinite escalators in the gas contracts subject to the NGA, but further stated it would not interpose any general objection to escalations in existing intrastate contracts.[16]

The Commission's next stage of development in the interpretation of indefinite pricing clauses came in Opinion No. 77.[17] This proceeding dealt with two settlement agreements containing clauses approximating area rates. An appeal to the 5th Circuit was dissmissed on May 20, 1981, without prejudice on the grounds it was not ready for review and was not final.[18]

Pennzoil and FERC: Judicial Review of Order No. 23

On the same day as Opinion No. 77 was being dismissed, the Fifth Circuit, under the same caption, *Pennzoil Co. v. FERC*,[19] decided that the NGPA neither precluded nor required area rate clauses to escalate interstate contract prices to the maximum lawful price.

In dealing with FERC jurisdiction to regulate or control gas purchase contracts, the court divided such contracts into four categories:[20]

1. Those gas contracts remaining within FERC jurisdiction under the NGA and not removed by NGPA § 601(a)(1) are priced under sections: 102(d)(2)* ("old leased-new OCS gas"), 104 ("old gas"), 106(a) (interstate "rollover" contracts), 107(c)(5)** ("high-cost, extraordinary risks or costs" gas), 108 ("stripper" well gas), and 109(a)(2) (committed and dedicated to interstate

[10] Natural Gas Policy Act of 1978: Interim Regulations, FERC Docket No. RM79-3, 43 F.R. 56448 (Dec. 1, 1978).

[11] FERC Policy Respecting Area Rate Clauses and Indefinite Price Escalator Clauses, FERC Docket No. RM79-22 (Jan. 24, 1979).

[12] Final Regulations Amending and Clarifying Regulations under the Natural Gas Policy Act and the Natural Gas Act, FERC Docket No. RM79-22, 44 F.R. 16895 (Mar. 20, 1979).

[13] Supra, note 10, mimeo at 45.

[14] Supra, note 10, mimeo at 28.

[15] Supra, note 10, mimeo at 63.

[16] Some nine days later, the Commission, in Order No. 23-B altered the procedure for protests by a third party that an indefinite escalator had been triggered through passage of the NGPA by shifting the filing burden to pipelines, based upon an analysis that the pipelines were better prepared to meet such burden rather than some of the smaller producers. 18 C.F.R. § 154.94(h) and (12), FERC Docket No. RM79-22, 44 F.R. 38834 (July 3, 1979).

[17] Independent Oil & Gas Association of West Virginia, FERC Docket Nos. RI74-188 and RI75-21, 10 FERC ¶ 61,214 (1980) *reh. denied,* 11 FERC ¶ 61,106 (1980), FERC Docket No. RM80-51, 45 F.R. 28085 (April 28, 1980).

[18] Pennzoil Co. v. FERC, 645 F.2d 394 (5th Cir. 1981).

[19] Pennzoil Co. v. FERC, 645 F.2d 360 (5th Cir. 1981).

[20] Pennzoil Co. v. FERC, supra, n.19 at 380.

commerce on November 8, 1978, with no just and reasonable rate under NGA).[21]

2. Gas that was committed or dedicated to interstate commerce on November 8, 1978, but is no longer within NGA jurisdiction by reason of NGPA § 601(a)(1)(B), is given an incentive price under section 102 (new gas), 103 (new onshore production well), or 107(c)(1)-(4) (high-cost gas).[22]
3. A hybrid of the first two categories; gas under an existing interstate gas purchase contract subject to a pending eligibility determination that it qualified for either section 102(c), 103, or 107(c)(1)-(4).[23]
4. Existing intrastate gas purchase contracts under section 105, and intrastate rollover contracts under section 106(b) of the NGPA, whether or not priced under that section.[24]

The Court gave approval to FERC jurisdiction over the first category of contracts remaining under the NGA, and the third conditionally, pending eligibility determination that the gas qualifies for a different pricing category. The second and third categories were held to be exempted by section 601(a)(1)(B) of the NGPA from FERC regulation and the final category remained exempt under section 601(a)(1)(A).

FERC applied general principles of contract law relative to area rate clauses in determining the authority to collect NGPA prices.[25] The decision affirmed the Commission's application of the "Mobile-Sierra"[26] doctrine upholding the Commission finding that contractual authorization is necessary for a seller to make a valid rate increase filing under section 4 of the NGA. Overall, Order No. 23 was upheld, the Court striking a balance between the producers' position that the NGPA had triggered all area rate clauses to new NGPA maximum lawful price ceilings and the consumers' contention that the NGPA and the NGA prohibited area rate clauses from so escalating.

Implications of Pennzoil Decision

It appears that *Pennzoil* may have reduced the FERC's options in dealing with certain categories of gas under the NGPA. The decision also casts some doubt on the applicability of the old FPC decisions dealing with the favored nation clauses under the NGPA at least for those categories of gas no longer subject to Commission control. The remaining gas which remains subject to NGA jurisdiction is not the cause of concern for escalation in 1985. Rather, it is the new gas scheduled for decontrol in 1985 not subject to NGA authority that fuels the legislative debate.

If the designated pricing categories of the NGPA and the *Pennzoil*

[21]NGPA § 601, 15 U.S.C. § 3431; §§ 3312(d)(2), 3314, 3316(a), 3317(c)(5), 3318, 3319 (Supp. 1978). *Outer Continental Shelf (OCS) gas from old leases in reservoirs discovered before July 27, 1976, was not identified by the Court but remains subject to NGA jurisdiction. **High-cost gas produced under such other conditions as the Commission determines to present extraordinary risks or costs was also omitted, but remains subject to Commission jurisdiction.

[22]NGPA § 601, 15 U.S.C. § 3431; §§ 3312, 3313, 3317(c)(1)-(4), Supp. 1978).

[23]Under NGPA § 503, 15 U.S.C. § 3413, state and federal agencies with regulatory jurisdiction over gas production determine whether gas so qualifies subject to FERC review.

[24]NGPA §§ 105, 106(b), 15 U.S.C., §§ 3315, 3316(b) (Supp. 1978).

[25]Pennzoil, 645 F.2d at 384; The Pennzoil Court held that state contract law was to be applied and suggested that the use of the Uniform Commercial Code (sale of goods), U.C.C. § 2-107(i) would solve state law uniformity questions; Pennzoil, 645 F.2d at 387. *See* Erie Railroad v. Thompkins, 304 U.S. 64, 58 S. Ct. 817 (1938).

[26]United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division, 358 U.S. 103, 79 S. Ct. 194 (1958); Federal Power Commission v. Sierra Pacific Power Co., 350 U.S. 348, 76 S. Ct. 368 (1956); United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332, 76 S. Ct. 373 (1956).

pronouncement seem to close the door on regulation under the NGA, what solace can be given those who would advocate FERC can, and should, "do something", and where should they next look?

NGPA Section 313 does provide a limitation on the operation of indefinite price escalation clauses: "No price paid in any first sale of high-cost natural gas . . . may be taken into account in applying any indefinite price escalator clause with respect to any first sale of natural gas other than high-cost natural gas . . . ."[27]

This provision is of some help in keeping high-cost gas already deregulated from triggering favored nation clauses in the thousands of contracts governing controlled gas scheduled for future deregulation. It may not avoid completely the wide-spread triggering of such clauses since there are purportedly many three-party contracts outstanding. High-cost gas does not have the corresponding impact of gas in sections 102 and 103, which makes the limitation on escalation less significant.

Voluntary contract negotiation between the private parties is a possible method of resolution of the problem but the potential for bargaining out is severely limited by take-or-pay clauses, which, among other things, tie pipeline's take-or-pay obligation to the pricing provisions of the contract.[28] Such voluntary renegotiation of contracts is beyond the scope of this Article.[29]

Incentive Initiatives

There have been comments submitted to FERC relative to incentives or choices that might be given to individual producers in exchange for renegotiating price clauses in existing contracts to be deregulated in 1985, or for gas which is currently deregulated under section 107(a).[30]

All producers might be given the opportunity to limit indefinite or definite escalator clauses so that the contract price would not rise above some reasonably predetermined market level or some surrogate reference price following deregulation in 1985. In exchange, the Commission would exercise its wellhead pricing authority to increase to a just and reasonable level an incentive price (possibly to promote market order) for all interstate gas covered by sections 104, 106 and 109. This would mean higher prices for these three categories, provided the renegotiation condition were met. Conditioning terms of private contracts in determinating eligibility for price categories is not new. This was the approach taken with "contractual effective date" terms in vintaging tiered contracts on a gradual basis. This was done to increase production incentives by treating replacement gas as

[27] NGPA 313, 15 U.S.C. § 3373(a), (Supp. IV 1980). This excludes § 107(c)(1)-(4) gas which is now deregulated. The other § 107 gas would be entitled to § 102 equivalent priced gas.

[28] Just 10.5% of interstate contracts for old gas with indefinite escalator clauses also contain renegotiation clauses which are contingent on the gas becoming unmarketable at the contract price. Decision Analysis Corporation, Analysis of Natural Gas Producer/Interstate Pipeline Contracts (1981). The sample for this study was taken from a sample of 200 gas purchase contracts on file with FERC. It included only contracts for sale or resale in interstate commerce executed prior to passage of the NGPA in 1978, and thus may not be an accurate estimate or sample.

[29] Mutual mistake and reformation under contract law as between the parties have been suggested as possible remedies. *See*, Pierce, "Natural Gas Regulation, Deregulation and Contracts," 68 Virginia L. Rev., No. 9, 63-115 (1982).

[30] In the Matter of Impact of the NGPA on current and Projected Natural Gas Markets, Notice of Inquiry, FERC Docket No. RM82-26-000, Comments of the Process Gas Consumers Group (April 28, 1982).

a sale of new gas.[31]

Similarly, judicial affirmation was given to the FERC when it traded higher rates and refund credits to producers contingent upon their finding and committing new gas reserves to the interstate market. It was further conditioned upon the producer's offering at least 50 percent of the new reserves to the pipeline or other purchaser to whom a refund was owed.[32]

But do any of these prior decisions and judicial mandates have any relevance now in the wake of the NGPA and Pennzoil? The general issue of Commission authority under the NGA and its juxtaposition with the NGPA was judicially explored in Columbia Gas v. FERC.[33] This decision dealt with the period when area rates proved too low to attract new gas to the interstate market, and interstate pipelines began suffering extensive curtailments in natural gas deliveries.[34] An effort was then made by the Commission to attract new gas for such market.[35]

A producer, Columbia Gas Development, upon enactment of the NGPA, attempted to obtain the higher NGPA section 104 rate, including the inflation adjustment. The Court found that NGPA section 104 incorporates by reference and carries forward prior FPC price regulation. The opinion concluded that an optional procedure certificate holder is unable to collect the increasing section 104 ceiling price because of such certificate holder's disability from making the NGPA § 4 rate increase filing necessary to lawfully collect a price higher than the certificated price. As the opinion noted:

> Rather than superseding the optional procedure certificate pricing and waiver conditions, the NGPA instead carries these conditions forward.[36]

Thus, an incentive program initiated under the NGA was affirmed after passage of the NGPA, but a crucial factor for such holding was that the gas involved remained subject to the NGA.

Assuming for the moment the relevance of Columbia for approval under the NGPA for optional conditions by FERC, the question arises as to how many producers would be willing voluntarily to exercise the regulatory "bargain out." Although producers are dependent upon the pipelines' solvency and continuing ability to market flowing gas while also purchasing future supplies sufficient to guarantee adequate reserves, it is a big sacrifice for some individual producers to forego such escalation.

There are royalty owners to consider as well as investment carrying charges to face. Three-party favored nations clauses limit the ability of any pipeline to avoid accelerated prices. As experience shows, merely one or two pipelines responding to a short-term incentive created by partial deregulation can create high prices. At

---

[31]Superior Oil Co. v. FERC, 569 F.2d 971 (5th Cir. 1978); Austral Oil Co., Inc., v. FPC, 560 F.2d 1262 (5th Cir. 1977); Shell Oil Co. v. FPC, 491 F.2d 82 (5th Cir. 1974); 15 U.S.C. §§ 717-717w. *See also* Permian Basin Area Rate Cases, 390 U.S. 747, 796-978. Sanction of differences in price for simultaneous sales of gas of identical quality, if differences effectively serve the regulatory purposes contemplated by Congress.

[32]Mobil Oil Corp. v. FPC, 417 U.S. 283, 94 S. Ct. 2328 (1974).

[33]651 F.2d 1146 (5th Cir. 1981).

[34]*See generally* Freeport Oil Co. v. FERC, 638 F.2d 702, 703-05 (5th Cir. 1980).

[35]FPC Order No. 455, 48 F.P.C. 218 (1972), Amended, Order No. 455-A, 48 F.P.C. 477 (1972), aff'd in part and set aside in part, Moss v. FPC, 502 F.2d 461 (D.C. Cir. 1974), aff'd in part, rev'd in part and remanded, 424 U.S. 494, 96 S. Ct. 1003 (1976). An optional procedure for certificating new producer sales of natural gas allowed producers to tender contracts for the sale of new natural gas at rates above the then prevailing ceiling rate. If the certificate was accepted by the producer, the rights to change the rate in later proceedings under section 4 of the NGA was waived.

[36]Columbia Gas v. Federal Energy Regulatory Commission, 651 F.2d 1146, 1156, 1157 (5th Cir. 1981).

some economic point, however, producers have an interest in maintaining a pipeline outlet for newly discovered gas supplies.

But suppose the incentive method and voluntary renegotiation do not succeed. Does FERC have the power to involuntarily abrogate the clauses under some condition which demonstrates that the regulatory purposes stated were contemplated by Congress?

Involuntary Termination by FERC

Assuming similar current market conditions 1985, such as an imbalance of the mix in supply between high-cost gas and cheaper, old gas, severe take-or-pay contract problems, exacerbated by a possible price "spike" in 1985 by indefinite escalators and favored nation clauses, it can be argued that the FERC, charged with the public interest duty of assuring an adequate supply of natural gas in the interstate market "at the lowest possible reasonable rate consistent with the maintenance of adequate service,"[37] can exert broad regulatory authority over such contracts. The authority for such action is the NGA if based on a reasonable regulatory purpose.

In the leading case on curtailment, *FPC v. Louisiana Power and Light*,[38] the Supreme Court affirmed the FPC's authority[39] over discrimination among a pipeline's customers. The regulation action was exerted over a curtailment plan exercised under the broad heading of "transportation" and the Commission's jurisdiction under section 1(b) of the NGA.[40] This and other curtailment cases[41] were decided on the rationale that comprehensive curtailment plans for gas in interstate commerce were beyond the competence of state regulatory agencies.

In answer to the question whether the pipeline sales and not the end-user purchases are subject to Commission jurisdiction, the U.S. Supreme Court[42] construed the NGA to grant jurisdiction over the interstate transportation of gas as a separate matter, whether the sale is for consumption or resale. Thus, a rather broad standard was pronounced which gave Commission regulaton of transportation an expanded range over end-user sales. Such sales are nonjurisdictional as a direct sale, Commission authority extending only to a sale for resale.

Section 1(a) of the NGA[43] charges that the business of transporting and selling natural gas is affected with a public interest, and section 16 of the NGA[44] grants the Commission administrative powers to "perform any and all acts . . . as it may find

[37]Atlantic Refining Co. v. Public Service Commission, 360 U.S. 378, 388 (1959).

[38]406 U.S. 621, 92 S. Ct. 1827 (1972). A jurisdictional pipeline experienced temporary shortages of natural gas supply, forcing it to curtail deliveries to its contract customers. The FPC asserted its transportation jurisdiction to effect a reasonable curtailment plan for deliveries to both contract and direct sales customers. Rate-setting authority over direct sales was excluded, the Court finding jurisdiction over interstate sales for resale only.

[39]The Commission's NGA powers of regulation cover three areas: (1) the transportation of natural gas in interstate commerce; (2) sales in interstate commerce for resale; and (3) natural gas companies engaged in such transportation or sale. Panhandle Eastern Pipe Line Co. v. Public Service Commission, 332 U.S. 507, 516 (1947).

[40]15 U.S.C. § 717(b).

[41]Mississippi Power & Light v. United Gas Pipe Line Co., 532 F.2d 412 (5 Cir. 1976), *cert. denied*, 429 U.S. 1094 (1977) (Breach of contract suit for curtailment damages gave the Commission first opportunity to rule under doctrine of primary jurisdiction).

[42]United Gas Pipe Line v. FPC, 385 U.S. 83, 89-90 (1966), citing FPC v. East Ohio Gas Co., 338 U.S. 464 (1950); FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1 (1961); Panhandle Eastern Pipeline Co. v. FPC, 359 F.2d 675 (8th Cir. 1975).

[43]15 U.S.C. § 717(a).

necessary and appropriate to carry out . . ."; thus, where the public interest is threatened, such authority would be available under a broad transportation standard to void or regulate indefinite escalators through the NGAA This broad-scale attack frames the issue squarely: Does the ability of the Commission to regulate the transportation and the sale of gas under the NGA, coupled with the judicial decisions of the FPC era finding indefinite escalators inimical to the public interest standing alone, provide the chemistry to void the offending clauses in light of the statutory changes of the NGPA and *Pennzoil*?

The countervailing argument that can be made in opposition to FERC jurisdiction will surely urge that Congress was cognizant of these problems when it drafted sections 105(b)(3)(A) and 313(a)[45] limiting indefinite escalators under specified conditions. Further, the global declaration by the Pennzoil Court will be used to offset the broad, public interest attack:

> "The NGPA is a fundamental change in regulatory outlook. Contrary to the Supreme Court's assumption in Phillips Petroleum Co. v. Wisconsin,[46] which subjected gas producers to utility-type regulation under the NGA, Congress apparently decided that gas producers do not have 'natural' monopoly power. . . . Therefore, the theory that a regulatory agency is necessary to represent consumers when they bargain on rates with a natural monopolist like a utility no longer applies to gas production. . . . FERC has a fundamentally different regulatory obligation, a narrower authority to administer the NGPA and to prescribe *higher* price ceilings only in certain circumstances. . . . The balance Congress struck already took into account the conflicting interests of producers and consumers." [emphasis in original; footnotes and citations omitted][47]

While a distinction may be drawn between price ceilings and contracting practices, the presence of statutory authorization by the NGPA for such price levels, coupled with a decision abrogating NGA jurisdiction over such price categories for gas, would argue against the power to void such contractual clauses.[48] Yet, arguments on both sides appear to have missing elements. There is another standard which must be examined before a complete solution to this problem may be tendered. Perhaps it will offer a path that will make the legal traverse less steep.

Fraud and Abuse Standard

Section 601(b)(1) of the NGPA provides that any amount paid in a first sale shall be deemed to be just and reasonable if that amount does not exceed the applicable maximum lawful ceiling price for the gas.

Section 601(c)(2) allows interstate pipelines to pass-through the price paid to purchase natural gas if the price, deemed just and reasonable, is not "excessive due to fraud, abuse or similar grounds."[49] The Commission in a statement of policy[50] limited the meaning of fraud to misrepresentation of price, using fraud and concealment as defined in The Restatement of Torts and by pronouncements of

---

[44] 15 U.S.C. § 717(o).

[45] Supra, note 27. Such provision also brings into play an argument that statutory specification of one exception to a general rule excludes other exceptions not expressed Supra, note 37, Columbia Gas v. FERC, 651 F.2d at 1156.

[46] 347 U.S. 672, 745 S. Ct. 672 (1954).

[47] Supra, note 19, 645 F.2d at 378-679, citing J. Bonbright, Principles of Public Utility Rates, 10-13 (1961).

[48] Pennzoil Co. v. Federal Energy Regulatory Com'n, 671 F.2d 119 (6th Cir. 1982).

[49] NGPA § 601(b)(1), 602(c)(2), 15 U.S.C.A. §§ 3301-3432 (Supp. 1978).

[50] Natural Gas; Fraud Standard; Statement of Policy, 18 C.F.R. § 2.300, FERC Stat. & Regs. ¶ 30,336, Docket No. PL82-1-000, 47 Fed. Reg. 6253 (Feb. 11, 1982).

Professor Prosser on Torts as guidelines.[51] The term "abuse and similar grounds" was given the same generic definition as "misrepresentation or concealment in disregard of a duty."[52] The statement also limited the authority over section 601(c) to instances of fraud or abuse within a single contract.

This limited standard thereafter served as a directive in several proceedings at the Commission which resulted in termination of the proceedings.[53]

Under a less restrictive definition of the term "abuse",[54] that the use of indefinite escalators and their inclusion in gas contracts with §§ 102(c), 103 and 107(c)(1)-(4) pricing categories, could be considered to be an abusive practice. The escalators were apparently agreed upon without any thought as to market reality, such provisions leading to an oversupply of high-cost gas that became unmarketable. The loss of customer load and resulting escalating gas costs from such loss, constitutes, in its totality, an abusive practice.[55] The right or privilege is identified specifically as the opportunity to pay incentive prices and pass those costs through without an inquiry of prudency being made.

Certainly abusive gas purchasing and acquisition practices might be shown to exist in a totality of all transactions, but only in exceptional circumstances could it be proved by an individual contract analyzed in isolation as required by the Commission's policy statement.[56]

---

[51] Restatement (Second) of Torts Section 525 (1977); W. Prosser, Handbook of the Law of Torts (4th ed. 1971) at 684; United States v. Neustadt, 366 U.S. 696, 711 n. 26 (1960) (quoting Prosser).

[52] Supra, note 51, mimeo at 42.

[53] Cities Service Gas Company, Docket No. TA83-1-43-005 (PGA 83-1) and RP82-114-003, (March 1, 1983); Texas Eastern Transmission Corporation, Docket Nos. TA82-2-17-000 and RP81-109-000, (February 4, 1983); Texas Gas Transmission Corporation, Docket Nos. TA82-2-18-000 and RP82-74-000, (February 4, 1983); Transwestern Pipeline Company, Docket Nos. TA82-2-42-000, TA82-42-001, RP82-130-000 and TA83-01-42-000, (February 4, 1983); Texas Eastern Transmission Corporation, Docket Nos. TA82-2-17-000 (PGA82-2) (IPR-82-2) and (DCA82-2) and RP81-109-000 (December 6, 1982); Cities Service Gas Company, Docket No. TA83-1-43-000 and Docket No. RP82-114-000, (December 6, 1982); United Gas Pipe Line Company, Docket Nos. TA82-2-11-000 and RP82-57-000, (December 6, 1982); Texas Gas Transmission Corporation, Docket Nos. TA82-2-18-000 and RP82-74-000, (December 6, 1982); El Paso Natural Gas Company, Docket Nos. TA83-1-33-001 and TA82-33-001, *et al.* and RP82-33-000, (December 3, 1982); Transwestern Pipeline Company, Docket Nos TA82-2-42-000, TA82-2-42-001, RP82-130-000 and TA83-1-42-000, (November 24, 1982); Tennessee Gas Pipeline Company, Docket Nos. TA82-2-42-001, RP81-54-000, RP82-12-001, and TA82-1-9-001, (October 1, (1982); Tennessee Gas Pipeline Company, Docket No. TA82-2-9-000, (June 30, 1982); United Gas Pipe Line Company, Docket No. TA82-2-11-000, (June 30, 1982); Columbia Gas Transmission Corporation, *et al.*, Docket No. TA81-1-21-001 (PGA81-1, IPR81-1, LFUT81-1, TT81-1, and AP81-1) Docket No. TA81-1-29-002 (PGA81-1, IPR (PGA81-1, DCA81-1, and LFUT81-1) Docket No. TA81-1-30-001 (PGA 81-1,) LFUT81-1, IPR81-1 and TT81-1), (April 30, 1981).

[54] Abuse may be defined as "the improper use of a right or privilege" analogous to an abuse of discretion. This is a much broader application of the term than misrepresentation or concealment of price in the determination of the disregard of a duty. *See,* Concurring Statement of Commissioners Holden and Hughes, Columbia Gas Transmission Corporation, FERC Docket No. TA81-1-21, 001 (PGA81-1, IPR81-1, LFUT81-1, TT81-1 and AP81-1), Order Clarifying Prior Orders and Denying Request for Oral Argument, April 30, 1981; Commissioner Hughes, Concurring in Part, dissenting in part, Tennessee Gas Pipeline Company, a Division of Tenneco, Inc., FERC Docket Nos. TA82-2-9-000 and RP81-54-000 and RP82-12-001, Order Denying Rehaering, (October 1, 1982).

[55] 15 U.S.C. § 3301-3432 (Supp. IV 1980); Statement of Policy, Notice of Inquiry, FERC Docket No. RM82-26-000, pp. 23-24, (April 28, 1982); see generally MacAvoy, The Natural Gas Policy Act of 1978, 19 Nat. Resources J. 811 (1979); Foster Associates, Transition to Decontrol: An Analysis of "Fly-Up," 15-18 (Sept. 1980).

[56] Supra, note 51, mimeo at 50.

Under sections 4 and 5 of the NGA,[57] any sale of natural gas for resale is subject to a finding that the rate or charge is just and reasonable. The NGPA in section 601(b)(1)[58] incorporated this concept by deeming any amount paid in any first sale of gas to be just and reasonable if such amount does not exceed the maximum lawful ceiling price applicable to a particular category of gas, or if there is no applicable ceiling price due to decontrol, the amounts would then be eligible for guaranteed pass-through under secton 601(c)(2).[59] As has been noted,[60] the only exception to this rule is if the Commission should find that "the amount paid was excessive due to fraud, abuse or similar grounds." If Commission policy were to declare that indefinite escalator or favored nation clauses were an abuse, there would be no guaranteed pass-through from such increases under such clauses,[61] with the pipeline then having to establish that the prices paid were just and reasonable under section 4 of the NGA in order to pass through the increases. If the pipeline failed to prove that the increased costs were just and reasonable, the Commission would then establish some reasonable market level or substitute reference prices for the gas or establish a contract or practice to be observed and in force thereafter. The pipeline, if it were denied pass-through by the Commission, would urge FERC to use its ancillary authority to temporarily suspend and modify certain provisions of the offending contracts on a "Mobile-Sierra"[62] finding that enforcement of such provisions of all the contracts would be detrimental and injurious to the public interest. Pennzoil could again prove to be a stumbling block since *Movile-Sierra* applies only to contracts subject to FERC jurisdiction under NGA. A final denial of pass-through would make it more difficult to reach agreement on contracts containing escalation clauses by the pipelines, but perhaps, at minimum, would encourage inclusion of regulatory caps on such contractual price escalations.

With the broad-based "transportation" therapy, an attempt is made to equate a market condition (supply-demand imbalance) to terms and conditions of service (delivery-curtailment) so as to fit under the FPC cases. In actuality, the real assertion is that prices are so high that the gas is unmarketable. Under this theory, however, the Commission does not have to review the sale for resale rates but merity "transportation authority" to alleviate the impact of the offending clauses. Such theory may suffer unless the regulatory review is performed under the fraud and abuse standard.

Any rate review conducted under sections 4 and 5 of the NGA employing a prudency standard, in the absence of NGPA § 601(c), isolates the remedy to a sole rate case review over fixed costs. Gas purchase costs, the bulk of the charge, would be

[57]15 U.S.C. §§ 717c, 717d (1976). Sec. 4(a): "All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, . . . shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful. (b) No natural gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, . . ." Sec. 5(a): "Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State Commission, or gas distributing company shall find that any rule, regulation, practice, or contract affecting [a] rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order . . ."

[58]NGPA § 601(b)(1), 15 U.S.C. § 3431(b)(1) (1982).

[59]Supra, note 50. This would also include a prohibition against denial of a certificate or conditioning the grant of one under section 7 of the NGA based upon the sales price for the gas.

[60]Supra, note 50.

[61]Supra, note 6.

[62]Supra, note 25.

eliminated from such inspection under the Commission's current policy statement.[63] In harmonizing section 4 or 5 rate review of the NGA with the fraud or abuse exception under the NGPA, it is to be noted that there is a major proceeding yet to be decided by the Commission which could alter the course of future policy relative to the definition of abuse.[64]

Conclusion

Indefinite escalator clauses in natural gas contracts may prove to be troublesome for industry, regulators and the consuming public in 1985. Absent legislation, the question will be: "Does the NGPA, mandating an 'efficient and economic operation' of the market standard, allow contractual prices for natural gas to escalate (if they do) beyond any reasonable market determined price, and what can FERC do about it?" Reliance upon historical precedents and authorities under the Natural Gas Act may not prove effective in controlling such clauses in the light of *Pennzoil v. FERC,* but the exercise of such authority, if effective at all, will have to be done on the basis of legitimate regulatory policy goals calculated to achieve some public interest policy determinant.

Incentive options by individual producers and the FERC offer some promise for elimination of indefinite escalators through alternative choice. While there is ample authority under the NGA for such incentive limitations, the nature of the clauses themselves may make for transactional barriers to a voluntary resolution between the parties.

Finally, examination will have to be made of FERC's ability to involuntarily terminate the clauses in the environment of the NGPA if market disorder and a different economy are present in 1985. Sections 1a, 4 and 5 of the NGA coupled with a finding of abuse under section 601(c) of the NGPA appear to present the best combination for a "stairway" leading to control of the clauses subject to the opportunity of the Commission to redefine abuse in the context of a major proceeding pending before FERC or in a general policy change. In short, a finding of public interest detriment, with the operation of the clauses, bolstered with NGA authority, may not be sufficient, absent abuse. This could also fail under the *Pennzoil* decision even with abuse.

[63] Supra, note 51.

[64] Columbia Gas Transmission Corporation, FERC Docket Nos. TA81-1001 and TA81-2-21-001, Initial Decision, 21 FERC ¶ 63,100. "In particular cases, both the underlying validity of the policy and its application to particular facts may be challenged and are subject to further consideration." Supra, note 30, mimeo at 2. (There is, of course, the possibility of a change in the Statement of Policy by the Commission as well.)