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Contract Law - Indefinite Price Escalation Clause in Natural Gas Sales Contract: Unconscionable and Contrary to Public Policy - Keer McGee Corp. v. Northern Utilities, Inc.; Northern Utilities Inc. v. Amoco Production Co. and Phillips Petroleum Co.

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CONTRACT LAW— Indefinite Price Escalation Clause in Natural Gas Sales Contract; Unconscionable and Contrary to Public Policy. *Kerr McGee Corp. v. Northern Utilities, Inc.; Northern Utilities, Inc. v. Amoco Production Co. and Phillips Petroleum Co.*, **500 F. Supp. 624 (D. Wyo. 1980).**

In 1957, Amoco Production Company ["Amoco"], Kerr McGee Corp. ["Kerr McGee"], and Phillips Petroleum Co. ["Phillips"] each entered into independent long-term intrastate contracts with Northern Utilities Inc. ["Northern"], a Wyoming public utility, for the sale of natural gas. In 1970, Amoco and Northern executed a Supplemental Agreement to this existing Gas Sales Contract which, among other things, extended the duration of the contract twelve (12) years.[1] More importantly, the Supplemental Agreement added a new indefinite price escalation clause to the contract which provided as follows:

> [6(b)] *From and after January 1, 1976,* when the price to be paid by Northern to Pan American (Amoco) pursuant to the other provision hereof is less than the sum of the price received for gas being sold in *interstate commerce, by any producer* within the State of Wyoming, except in the counties of Uinta and Lincoln, plus three cents per one thousand cubic feet (3¢ Mcf), then Northern shall increase the price to be paid Pan American hereunder to a price equal to the price being received by such producer plus three cents per Mcf."[2]

This clause was inserted as an alternative to the base prices provided in the contract; its purpose to insure that the contract price would maintain market relevance over the entire term of the contract. Hence, whenever the price paid to *any purchaser* in *interstate commerce* exceeded the base price set out in the contract, the contract price automatically escalated to that new, higher price. In 1973, similar written amendments containing clause 6(b) were executed by Northern and Kerr McGee and Northern and Phillips.[3]

In 1975, the producers advised Northern that clause 6(b) had been "triggered" because the prices being received by other producers of gas in Wyoming for sales in interstate commerce were greatly exceeding the amount being paid to the producers under the base price provisions of the Gas Sales

1. Kerr-McGee Corp. v. Northern Utilities, Inc., 500 F. Supp. 624, 628 (D. Wyo. 1980).
2. *Id.* at 628 (emphasis added).
3. *Id.* at 627.

Contracts.[4] Consequently, the contract price rose dramatically through the operation of clause 6(b). By the time of the trial in 1980 the producers were claiming the interstate rate of $2.80 per million cubic feet (Mcf) through clause 6(b)—approximately ten times more than the base price established for 1980 under the contract.[5]

Northern brought suit against the producers in federal court on the grounds that clause 6(b) was ambiguous and contrary to public policy.[6] The district court for the district of Wyoming concluded that owing to the "exorbitant" rates being passed along to consumers, clause 6(b) was void as against public policy and unconscionable under Section 34-21-219 of the Wyoming Statutes. The court struck the clause from the contract, but enforced its remainder until expiration in 1990. Finally, the court ordered the producers to return to Northern the amount collected through the operation of clause 6(b)[7]—a total of $59,603,631.[8]

This note will begin by providing background information necessary to place the public policy issue of natural gas regulation into context. Attention will be focused on the changing rate-setting policies of the Federal Power Commission (FPC)[9] from the enactmant of the Natural Gas Act in 1938 to the present. Next, the reasoning behind the district court's decision will be briefly explained. Finally, the court's decision will be analyzed and critiqued.

BACKGROUND: NATURAL GAS REGULATION

Before the enactment of the Natural Gas Policy Act of 1978 (NGPA),[10] the federal government had jurisdiction over natural gas sales in *interstate* commerce under the Natural Gas Act of 1938.[11] In 1938, the states regulated the sale of

4. *Id.* at 631.
5. *Id.* at 633.
6. Brief for Appellant Amoco Production Company at 11, Kerr-McGee Corp. v. Northern Utilities, Inc.; Northern Utilities, Inc. v. Amoco Production Co. and Phillips Petroleum Co., Nos. 80-2273, 2274, 2275 (10th Cir., argued Sept. 30, 1981) [hereinafter cited as Amoco Brief]. The issue of unconscionability was raised by Northern after the close of evidence when it filed its memorandum brief. *Id.*
7. Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 636.
8. Amoco Brief, *supra* note 6, at 1.
9. Pursuant to the National Gas Policy Act the Federal Power Commission became the Federal Energy Regulatory Commission (FERC). 15 U.S.C. § 3301(24) (Supp. III 1979).
10. Pub. L. No. 95-621, §§ 1-602, 92 Stat. 3350 (codified at 15 U.S.C. §§ 3301-3432 (Supp. III 1979)) [hereinafter cited in text as NGPA].
11. Pub. L. No. 75-688, §§ 1-24, 52 Stat. 821 (codified at 15 U.S.C. §§ 717-717w (1976)).

natural gas by application of a "fair value" test; prices were fixed in order to allow a rate of return based on the reproduction costs of capital investment. In 1942, the FPC departed from this rate scheme by adopting a policy which allowed only "actual legitimate costs" to be used as the basis for a "just and reasonable" rate of return.[12] This policy became known as the "prudent investment approach"[13] and was approved by the Supreme Court in *FPC v. Hope Natural Gas*.[14]

With this methodology of determining rates of return by reference to the costs of the individual producer, it appears logical that the FPC would oppose the operation of indefinite price escalation clauses. In fact, the FPC in its Order No. 232[15] banned the use of indefinite price escalation clauses[16] in *interstate* sales contracts. In Order No. 232, the Commission objected to the adverse effect of these clauses which, in its opinion, led to rates based not on the historic cost basis, but on the collection of such a rate by another producer.[17] Hence, in the eyes of the FPC, such clauses were "incompatible with the public interest."[18]

By 1960, however, the FPC had determined that setting rates on a company-by-company cost approach was no longer administratively feasible.[19] The Commission instead adopted the policy of regulating prices on an area basis, whereby aggregate profits for the industry would be determined for various producing areas around the country. The "area rate" basis of regulation also set two prices for each producing area. "Vintage pricing," as it came to be known, allowed higher prices for "new" contracts (contracts entered into on or after January 1, 1961) as an incentive for producers to engage in further exploration and development; "old" contracts were

12. Comment, *Natural Gas Rate Regulation: The Conflict in the Application of the Just and Reasonable Standard*, 12 TULSA L. J. 293, 304 (1976).
13. *Id.*
14. 320 U.S. 591 (1944).
15. 25 F.P.C. 379 (1961).
16. Examples of indefinite escalation clauses include:
(a) Two-party favored nation clauses, which are activated by higher prices paid to any other supplier by the same purchaser;
(b) Three-party favored nation clauses, which are activated by higher prices paid to any other supplier by any purchaser.
For other examples *see* Pure Oil Co., 25 F.P.C. 383, 388 n.3 (1961).
17. *See* Pure Oil Co., *supra* note 16, at 389.
18. FPC Order No. 232, *supra* note 15, at 380.
19. Manning, *Federal Regulation of Pricing Provisions in Natural Gas Sales Contracts—From the Phillips Decision to the Natural Gas Policy Act of 1978*, 16 HOUS. L. REV. 1081, 1088 (1979) [hereinafter cited as Manning].

held to lower rates because they were associated with lower costs.[20] Thus, vintage pricing was intended to serve the public interest by balancing the interests of the consumer and the investor.

This balance, however, became threatened as the United States' energy scenario began to reflect shortages. Put simply, the price of gas proved too low to meet market demand.[21] As early as 1969, the FPC recognized the impending shortage, noting a downward trend in the gas reserves to the gas production ratio.[22] In 1972 the FPC Staff wrote that the "emergence of a natural gas shortage during the past two years marks a historic turning point—the end of natural gas industry growth uninhibited by supply considerations."[23]

In order to stimulate investment and increase supplies the FPC abandoned area rate regulation in favor of establishing a just and reasonable *national* rate for new gas.[24] In Opinion No. 770,[25] the FPC recognized that certain *non-cost* factor should be considered in setting rates. The price of competitive fuels, the impact upon supply and demand, inflationary pressures, the nation's natural gas shortage, and conservation were all recognized by the FPC as important factors to be considered along with cost in the setting of just and reasonable rates.[26] Opinion No. 770 increased the uniform national rate by 270%, but the FPC reasoned that consumers would benefit in the "longer run" by those higher costs. Higher costs, according to the FPC, would lead to increased gas supply and greater gas conservation, and would make more gas available for residences, businesses, and industrial consumers.[27]

In 1978 Congress passed the Natural Gas Policy Act which expanded the jurisdiction of the FPC's successor agency, the Federal Energy Regulatory Commission (FERC), to include both interstate and *intrastate* sales.[28] Under the Act, natural

20. *Id.* at 1089.
21. Comment, *supra* note 12, at 309.
22. *Id.* at 309, n.87.
23. Comment, *supra* note 12, at 310 n.91 (quoting U.S. FEDERAL POWER COMMISSION, STAFF REPORT NO. 2, NATIONAL GAS SUPPLY AND DEMAND 1971-1990 (1972)).
24. Manning, *supra* note 19 at 1090. "New" gas was determined to be gas produced after December 31, 1972. *Id.* at 1091.
25. [1976] 10 FED. POWER SERV. (Matthew Bender) 5-293.
26. Manning, *supra* note 19, at 1092.
27. *Id.* at 1092-93.
28. 15 U.S.C. § 3301 (15), (16), (24) (Supp. III 1979).

gas is priced by Congressionally authorized ceilings designed to balance the goals of providing incentive for exploration and protection for consumers. This balance is struck by departing from cost-based gas pricing with respect to "new" incentive gas and retaining a combination of cost-based and non-cost factors in the pricing of "old" gas.[29]

Significantly, and perhaps indicative of these underlying changes in pricing policy, the Commission's Order No. 23 approved (or more accurately, declined to preclude) the operation of certain indefinite price escalation provisions.[30] In regard to interstate sales contracts the Commission determined,

> the Commission's regulations . . . do not preclude the operation of price escalation provisions in a contract, the terms of which specifically permit escalation to congressionally or legislatively authorized prices or which specifically reference the Natural Gas Policy Act prices.[31]

And, more significantly for the purposes of this discussion, the Commission opined that with respect to existing intrastate sales contracts,

> As a general matter, fixed price and indefinite price escalator clauses in existing intrastate contracts may permit escalation of the price under the contract in accordance with the terms of that contract . . . . escalator clauses may permit an increase in the contract price up to but not in excess of the current new natural gas price under section 102 of the Natural Gas Policy Act. Questions of contract interpretation are left, in the first instance, to the parties to the contract. In the event of their disagreement, the question should be left to state courts to resolve.[32]

The NGPA mandated that substantial decontrol of natural gas prices is in the best interest of the United States; under the Act, a significant portion of the nation's gas will be deregulated by 1987.[33] Notably, President Reagan's advisors

29. Manning, *supra* note 19, at 1094.
30. *Id.* at 1083-84.
31. *Id.* at 1084 (quoting [1979] 17 FED. POWER SERV. (Matthew Bender) 5-261).
32. *Id.* (quoting [1979] 17 FED. POWER SERV. (Matthew Bender) 5-262).
33. *See* 15 U.S.C. § 3331 (Supp. III 1979).

are currently recommending that he press for faster and more complete decontrol of both newly discovered gas and "old" gas.[34] Hence, it appears that United States natural gas policy may soon reflect deregulatory attitudes even more dramatically than does the NGPA. Certainly, those changes will have a very large impact on the consumer's natural gas bill. It is the premise of deregulation, however, that this negative impact is necessary to stimulate the positive goals of increasing supplies, encouraging conservation, and building national energy independence.[35]

THE COURT'S DECISION

The district court pointed out very early in its "Conclusions of Law" that this case involves a substantial public interest since Northern receives approximately 85% of its gas under the contracts involved in this case.[36] The price of this gas, the court noted, increased under the contracts through clause 6(b) from a price of .28 cents per Mcf in 1975 to $2.80 per Mcf in 1980; this translated, in the court's judgment, to an increase in the consumers' monthly gas bill from $30 per month to approximately $250 per month.[37] These dramatic increases could have a "devastating" impact on the communities served by Northern.[38] Further, held the court, "paragraph 6(b) causes windfall profits and substantially increases the costs to consumers for a commodity without which they may well not be able to live."[39]

These general views regarding the extremely adverse effects of the clause upon the public interest certainly influenced the court's reasoning in reaching its specific legal conclusion that the clause was both "void as against public policy" and "unconscionable" under Section 34-21-219 of the Wyoming Statutes. Unfortunately, for purposes of analysis, the court beyond this generally bakes the public policy issue and the unconscionability issue in the same pie, making it difficult to

34. Hershey, *The New Battle Over Natural Gas*, N.Y. Times, Sept. 6, 1981, § 3, at 1, col. 1.
35. *See* MacAvoy, *The Natural Gas Policy Act of 1978*, 19 NAT. RESOURCES J. 811 (1979).
36. Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 633.
37. *Id.* The court's conclusion about the increase in the consumer's gas bill has been severely criticized by the producers on appeal. They argue that these figures are derived from a hypothetical situation rather than the actual situation. The producers contend that, rather than $250, the average monthly gas bill would be $46.80. *See* Amoco Brief, *supra* note 6, at 33.
38. Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 636.
39. *Id.*

determine which specific ingredients make the clause unconscionable and which specific ingredients make it contrary to public policy.

Certain circumstances surrounding the negotiation of the Supplemental Agreement, however, appear to constitute the underpinnings of the court's unconscionability conclusion. The court states that clause 6(b) was designed by Amoco's legal counsel and was a "unique provision" not in common use in the industry.[40] Moreover, the producers "were aware of the then current proposals to change ceiling prices and methods concerning them as stated in the notices of the F.P.C."[41] Northern, on the other hand, "did not contemplate nor was it suggested by any other party that FPC pricing practices then existing and contemplated would materially or substantially change during the term of said contracts."[42] Finally, clause 6(b), "as intended by the producers, would remove all price restraints from the contract and fix a then indefinite price that would result in windfalls to the producers . . . and harsh results to the consumer."[43] These factors, it appears, constitute the court's major supports for finding the clause unconscionable at the time of its making.

The above considerations also flowed over into the court's conclusion that the clause was contrary to public policy. Certain other factors, however, appear more important to the court in its public policy determination. First, the court generally attacks indefinite price escalator clauses by citing unfavorable language concerning them in FPC and judicial opinions. The Supreme Court, for example, held in a 1968 decision that indefinite escalator clauses by their design and function alone may be incompatible with the public interest because of their artificial relation to the economics of a particular operation.[44] Similarly, a Tenth Circuit concurring opinion was cited which stated that: "These clauses naturally grant an advantage to the seller. As such they have generally been construed in favor of the buyer against the seller. Neither the courts, nor regulatory agencies have looked upon them with favor."[45]

40. *Id.* at 628-29.
41. *Id.* at 635.
42. *Id.* at 632.
43. *Id.* at 635.
44. In re Permian Basin Area Rate Cases, 390 U.S. 747, 783 (1968).
45. Superior Oil Co. v. Western Slope Gas Co., 604 F.2d 1281, 1295 (10th Cir. 1979) (concurring opinion).

Significantly, on this point the district court distinguished a 1980 Wyoming Supreme Court decision, *Amoco Production Co. v. Stauffer Chemical Co. of Wyoming,*[46] which upheld the validity of such a clause; the district court distinguished *Stauffer* factually and on the grounds that the public policy issue was not directly before the court.[47]

The district court's second major justification for invalidating the clause on public policy grounds rests on its finding that the effect of clause 6(b) was contrary to the pricing policies of the FPC. Those policies, held the court, set prices for interstate commerce by determining the "producers' costs plus a reasonable return on investment"—not the method by which prices were set by clause 6(b).[48] In addition, the court pointed out that the rates demanded by the producers were intended by the FPC to apply only to such contracts that exhibited certain "conditions precedent", namely, that the gas be "new" and the producers be "small". Since neither condition was fulfilled under this contract, the court held that the producers' demands were void as against public policy and unconscionable.[49]

Hence, the court struck clause 6(b) from the contract and ordered the producers to return the rates collected through its operation[50]—a sum of $59,603,631.[51] The court chose to enforce the remainder of the contract, setting the contract price at the previously negotiated base price determined for each year under the contract.[52] These prices will apply until the contract's expiration in 1990.

ANALYSIS OF THE COURT'S DECISION

Unconscionability

The State of Wyoming has adopted the Uniform Commercial Code provision on unconscionable contracts. It reads in part as follows:

46. 612 P.2d 463 (Wyo. 1980).
47. Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 636.
48. *Id.* at 632.
49. *Id.* at 635.
50. *Id.* at 636.
51. Amoco Brief, *supra* note 6, at 1.
52. Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 636.

> § 34-21-219 Unconscionable contract or clause.
>
> (a) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.[53]

The parameters of this provision have been elucidated by the Wyoming Supreme Court in *Estate of Frederick.*[54] In *Frederick,* the court held that unconscionability "is tested as of the *time the agreement* is made and not in accordance with hindsight"[55] (emphasis added). In addition, the *Frederick* decision spelled out other considerations to be looked at in determining unconscionability. These considerations were recently reiterated in a 1980 Wyoming Supreme Court decision:

> Other courts have indicated that in the context of the formation of the contract, it is important to determine whether the [persons claiming that the contract was unconscionable] were deprived of meaningful choice as to whether to enter into the contract; whether [the persons claiming that the contract is unconscionable] were compelled to accept the terms; whether there was opportunity for meaningful negotiation; and, whether there was such gross inequality of bargaining power that negotiations were not possible for the aggrieved party, or whether the aggrieved party was underprivileged, uneducated or illiterate and the type of person easily deceived or taken advantage of, or whether the aggrieved party could comprehend and was aware of the agreement or was in some manner surprised by fine print or concealed terms.[56]

The district court appears to have discounted the importance of *Frederick;* there is no mention of the case and it is difficult to understand how the facts of the present case could be squared with *Frederick's* parameters. Several important observations result from an analysis of the negotiation of the Supplemental Agreement: 1) There is little indication of a

53. WYO. STAT. § 34-21-219 (1977); U.C.C. § 2-302.
54. 599 P.2d 550 (Wyo. 1979).
55. *Id.* at 556 (emphasis added).
56. Cline v. Safeco Insurance Co., 614 P.2d 1335, 1338 (Wyo. 1980) (citations omitted).

deprivation of meaningful choice; Northern exercised its *right* under the original Gas Sales Contract to negotiate for the purchase of additional gas.[57] 2) Northern was not compelled to accept the terms; it bargained successfully for a twelve-year extension of the original contract.[58] 3) Northern was not deprived of an opportunity for meaningful negotiations; the negotiations lasted for over five months.[59] 4) There is no indication of a gross inequality of bargaining position; Northern is a large public utility which was represented by an experienced attorney at the negotiations.[60] 5) Clause 6(b) was not in fine print or concealed; rather, the clause was the major concession granted by Northern in exchange for the extension of the contract.[61]

The *Frederick* parameters refer to aspects of "procedural" unconscionability, or, as one commentator has put it, "bargaining naughtiness."[62] Put simply, "procedural" unconscionability corresponds to the conduct surrounding the negotiation of a contract; "substantive" unconscionability, on the other hand, refers to the unjust result of a contractual agreement. Procedural and substantive unconscionability naturally go hand in hand, unfair results predictably following unfair negotiation. In fact, it is only on the very rarest of occasions that courts have voided a contract or a clause without both aspects of unconscionability present.[63]

As suggested above, this case does not appear to present typical or striking aspects of procedural unconscionability of the kind outlined in *Frederick*. The district court, however, does suggest three factors which perhaps suggest the presence of an element of advantage taken during the negotiation of the Supplemental Agreement: 1) The uniqueness of clause 6(b) that was drafted by sophisticated Amoco attorneys, 2) The producer's knowledge and Northern's ignorance of forthcoming changes in FPC rate setting procedures, and 3) The intention

57. Amoco Brief, *supra* note 6, at 34.
58. *Id.*
59. *Id.*
60. *Id.*
61. *See id.* at 35.
62. Leff, *Unconscionability and the Code—The Emperor's New Clause,* 115 U. PA. L. REV. 485, 487 (1967), *quoted in* WHITE & SUMMERS, UNIFORM COMMERCIAL CODE 151 (2d ed. 1980).
63. *See* WHITE & SUMMERS, UNIFORM COMMERCIAL CODE, *supra* note 62, at 163-66. Research indicates that courts have never voided a clause or contract between *merchants* on unconscionability grounds in the absence of aspects of "procedural" unconscionability.

of the producers to remove price restraints leading to windfalls for themselves and harsh results for consumers. Taken together, these three factors suggest a scenario of Northern agreeing under subtle pressure to a clause it did not want nor fully understand. This conclusion, however, is vulnerable to several criticisms.

First, clause 6(b) is not unique in the industry. It is a representative example of a third-party favored nation's clause used extensively in the industry. E. Neuner, an expert in the natural gas contract area defines a third-party favored nation's clause as one in which "the buyer is obligated to pay to the seller the equivalent of any higher price which a third-party purchaser may subsequently pay for a comparable quantity of gas within a defined geographical area."[64] Notably, this definition appeared in Neuner's book ten years before the negotiation of this clause. Similarly, a 1955 Congressional hearing pointed out that favored-nation's clauses were "prevalent in the industry as early as 1947."[65]

Perhaps the district court's primary concern here is not the uniqueness of clause 6(b) in the industry, but its newness in Northern's eyes. Hence, the novelty of the clause to Northern, coupled with the shrewd and sophisticated negotiation of the Amoco attorneys may certainly suggest a situation where Northern was "outgunned" at the bargaining table. The question remains, however, whether this constituted an unfair "overreaching" of Northern.

Certainly, Amoco's tremendous resources and business savvy would be relevant considerations in determining whether it had unfairly taken advantage of a *consumer* during negotiations. In consumer contracts, courts have often held that these considerations point to an inequality of bargaining power that may, in some circumstances, facilitate the consumer's release from his contract obligation.[66]

64. NEUNER, THE NATURAL GAS INDUSTRY 265-66 (1960), *quoted in* Amicus Curiae Brief of Legal Foundation of America at 8, Kerr-McGee Corp. v. Northern Utilities, Inc.; Northern Utilities, Inc. v. Amoco Production Co. and Phillips Petroleum Co., Nos. 80-2273, 2274, 2275 (10th Cir., argued Sept. 30, 1981).

65. *Amendments to the Natural Gas Act: Hearings on S. 712 Before the Senate Comm. on Interstate and Foreign Commerce*, 84th Cong., 1st Sess. 1593 (1955), *quoted in* Amicus Curiae Brief of Legal Foundation of America, *supra* note 64, at 8.

66. *See* WHITE & SUMMERS, UNIFORM COMMERCIAL CODE, *supra* note 62, at 153.

Unlike the consumer, however, Northern as a large public utility would seemingly possess the necessary resources to bargain with strength against Amoco. There is no evidence of a gross inequality in bargaining power between Northern and Amoco. The district court, however, appears to look beyond the two-party contractual relationship to include the consumer's interest in the bargaining equation. In this way, Northern becomes the "representative of the consumer," the contract for the sale of gas becomes a "consumer sale," and Amoco's behavior is judged as if it were bargaining across the table from the consumer.

This view of the contract appears to have some inherent merit when considering that it is the consumer who will ultimately bear most of the burden and receive most of the benefit from the bargain between Northern and Amoco. Obviously, such an approach invests a public utility with extraordinary protection against "overreaching". In fact, it appears that this view of the contract would introduce issues of unequal bargaining power and procedural unconscionability in every contract between a utility and a large business entity. This inherent procedural unconscionability could conceivably be cited anytime a utility desired to escape from a contract with allegedly unconscionable results.

Very much related to this issue is the district court's suggestion that the producers acted improperly when they bargained for clause 6(b) while knowing of impending FPC price setting changes. This, according to the court's analysis, amounted to an unfair advantage because Northern was ignorant of any possible pricing changes.[67] The import of this reasoning is clear: The producers owed Northern some "duty to disclose" any information they may have had about possible FPC changes and the effect of those changes on clause 6(b).

The general rule on this point is that "it is not necessarily fraudulent for one party to a bargain consciously to take advantage of the ignorance or mistake of the other party, provided . . . there is no duty of disclosure arising from a *special* or *fiduciary relation* of the parties based on trust or confidence."[68] On the surface, a special or fiduciary relation-

67. *See* Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 630, 632.
68. WILLISTON, 12 CONTRACTS § 1497 (3d ed. 1970) (emphasis added).

ship of the kind traditionally recognized by courts does not appear to exist between the parties to this contract.[69] The district court's opinion, however, suggests that just such a relationship grows out of Northern's special obligation to act in the public interest. The court's sharp criticism of the producer's "disregard" of the interest of Northern and the public in seeking "to remove price restraints" leading to "harsh results" for consumers[70] seems to indicate that the producers had some duty, along with Northern, to act in the public interest. If one accepts the existence of a special relationship between the parties, then the actions of the producers (such as the use of a "new" clause, failure to disclose information, intent to extract the highest possible price, and generally shrewd and resourceful bargaining behavior) can all be viewed as an avoidance of their special obligation to Northern and the public. Such an avoidance appears to provide the district court with a basis for its finding of "procedural" unconscionability.

One searches in vain, however, for judicial precedent creating a special or fiduciary relationship between a public utlilty and the private entities with which it contracts; nor has research produced cases where the consumer was deemed effectively "present" in the form of a utility in the negotiation of contracts between a utility and a private entity. If either or both of these conclusions are the implicit holdings of the district court, the amount of judicial protection extended to consumers against "unfair" prices for their use of utilities is indeed extensive.

Judicial protection in this form, however, may create serious policy problems. First, parties will probably be discouraged from contracting with public utilities because of uncertainty regarding those parties' obligations during negotiations. Second, those parties who do contract with public utilities may desire increased "compensation" for the increased risk involved. Such compensation could take the form of higher prices or lower supply dedications. Finally, the court's decision tends to place the public utility in a favored position by insulating it from making mistakes. This could very well create disincentives to efficient and effective management.

69. *See id.* § 1497 n.3.
70. *See* Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 632, 634, 635.

It is suggested that the court could have avoided this venture into uncharted waters by concentrating less on the producer's "badness" and the public interest and more on the element of surprise inherent in the case. Put simply, Northern was surprised that prices went as high as they did. It appears that the producers, too, were surprised.[71] Under these circumstances, perhaps the doctrine of impracticability might constitute a more appropriate tool than unconscionability for purposes of voiding clause 6(b). Impracticability excuses the performance by a party to a contract if that performance has been made impracticable by "the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made. . . ."[72]

Certainly, both parties to this contract assumed prices might, and probably would, increase. But it is almost as certain that both parties assumed that prices would not increase as quickly and as drastically as they did owing to the unexpected severity of the 1970's energy shocks. The impracticability defense has been recently urged by *sellers* of energy resources seeking to avoid the very low prices they had committed to in their long-term contracts. The underpinning of these sellers' argument is that they relied upon the assumption that the energy market would remain somewhat stable in the seventies.[73] Northern's plight as a buyer, although inverse, is analogous to the plight of these sellers. Perhaps the application of impracticability doctrine in this case would address the facts of this controversy with less doctrinal manipulation and fewer adverse policy ramifications than is involved with the application of the unconscionability doctrine.

Public Policy

The district court also held that clause 6(b) was invalid as against public policy. Certainly, part of the court's decision in this regard is tied to its stance on the unconscionability of

71. *See* Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 632.
72. WYO. STAT. § 34-21-278 (1977); U.C.C. § 2-615.
73. Courts in these cases have looked both to the foreseeability of the occurrence of the contingency and the severity of the price increases involved. The greater the foreseeability of the contingency and the smaller the price increase involved, the smaller are the chances of excuse on impracticability grounds. *See* Wallach, *Excuse Defense in the Law of Contracts*, 55 NOTRE DAME LAW. 203 (1980). Although the express language of U.C.C. § 2-615 refers to *sellers*, Comment 9 states that the "reason of the present section may well apply and entitle the *buyer* to the exemption." U.C.C. § 2-615, Comment 9 (emphasis added).

clause 6(b); it would appear that by definition an unconscionable clause is also contrary to public policy. The court, however, appeared to rely on two additional factors in its public policy determination that were largely unrelated to unconscionability. First, the court noted the suspect nature of indefinite price escalation clauses in general as evinced by the opinions of various courts and the FPC. Second, the court criticized the effect of clause 6(b) as being contrary to the pricing policies of the FPC.

Indefinite Price Escalation Clauses in General

The United States Supreme Court in *In re Permian Basin Area Rate Cases* upheld the FPC's new "area rate" policy for setting prices for interstate gas sales.[74] It also reiterated its approval of the FPC's 1961 prohibition of indefinite price escalation clauses in interstate gas sales contracts where such clauses escalated prices above the area maximum rates. (*See* Background). Quoting the FPC, the Supreme Court wrote: "Indefinite escalation clauses 'cause price increases to . . . occur without reference to the circumstances or economics of the particular operation, but solely because of what happens under another contract'."[75] Similarly, a concurring opinion in the Tenth Circuit case of *Superior Oil Co. v. Western Slope Gas Co.*[76] quotes extensively from FPC Order No. 341 which attacks the economic artificiality of such indefinite price escalators.[77]

The district court relied heavily upon the above opinions in its general attack on indefinite price escalators.[78] These opinions do establish significant authority for the proposition that indefinite price escalator clauses may be contrary to public policy—even in intrastate contracts. More recent authority, however, challenges this view.

After the adoption of the Natural Gas Policy Act of 1978, the FERC promulgated Order No. 23[79] which permitted the operation of certain price escalation provisions in both

74. In re Permian Basin Area Rate Cases, *supra* note 44.
75. *Id.* at 782-83.
76. 604 F.2d 1281 (10th Cir. 1979).
77. *Id.* at 1295 (concurring opinion).
78. *See* Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 635-36.
79. [1979] 17 FED. POWER SERV. (Matthew Bender) 5-253.

interstate and intrastate contracts. In regard to intrastate contracts the Commission wrote:

> As a general matter, fixed price and indefinite price escalator clauses in existing intrastate contracts may permit escalation of the price under the contract in accordance with the terms of that contract. In a case where section 105(b)(1) of the Natural Gas Policy Act applies, escalator clauses may permit an increase in the contract price up to but not in excess of the current new natural gas price under section 102 of the Natural Gas Policy Act. Questions of contract interpretation are left, in the first instance, to the parties to the contract. In the event of their disagreement, the question should be left to the state courts to resolve. . . .[80]

Perhaps because of its recent origin this language was not available to the court in its examination of the controversy in this case. Nonetheless, Order No. 23 is a more current piece of evidence which demonstrates an acceptance of escalation clauses by the FERC in contrast to the more antagonistic views of the FPC in the sixties. It is suggested that Order No. 23 indicates that an analysis by the district court of more recent expressions of federal energy policy in the current era of shortages may have cast a significantly more favorable light on indefinite price escalation clauses.

With the FPC-FERC's consideration of non-cost factors in the pricing of gas, and the current moves toward deregulation, (*See* Background), it appears that the reasons behind opposition to such clauses are becoming less compelling. With the nation's new emphasis in increasing supplies and encouraging conservation, no longer do prices set by reference to what other producers are receiving (the market price) appear so "artificial"; nor, with these goals in mind, does it seem clear that higher prices set by escalation clauses are against the public interest. As one commentator has stated: "A low price is an admirable objective only if there is gas available; the consumer is not benefited by a low price if there is no gas to be supplied."[81]

At any rate, even if the FPC's opinions before the enactment of the NGPA constituted a clear mandate that indefinite

80. *Id.* at 5-261 to 262, *quoted in* Manning, *supra* note 19, at 1084.
81. Comment, *supra* note 12, at 317.

price escalator's were contrary to public policy in interstate sales, it must be recalled that the FPC's authority at that time did not extend to *intrastate* sales of gas. Hence, the FPC opinions are valid only for purposes of extrapolation in determining what is public policy for *intrastate* sales.[82] Indeed, this is the states' arena in which to set policy, which the Committee on Conference for the NGPA made clear in 1978:

> The conference agreement also cedes the Federal Government's authority to further limit the operation of indefinite price escalator clauses to state governments wishing to do so. The Congress, by adoption of this section, recognizes the right of states to prescribe more stringent limitations on the operation of such clauses than those prescribed herein.[83]

The State of Wyoming has enacted no legislation limiting the operation of such clauses. The Wyoming Supreme Court in *Stauffer* approved the operation of a clause all but identical to the one at issue in this case.[84] The court wrote in *Stauffer:*

> Favored nation clauses are a common feature of gas purchase and sale contracts. The nature of the product and its questionable availability engenders reluctance on the part of producers to enter into long-term contracts at the price prevailing at the time of the contract. Yet purchasers require long-term commitments to ensure an adequate supply of gas. . . . A third-party favored nations clause requires the purchaser to match any higher price contracted to be paid by any other buyer in the same field or area. *Favored nations clauses are recognized by the courts.*[85]

The district court distinguished *Stauffer* on the grounds that the "public policy issue was not before the court."[86] To the

82. *See* 16 AM. JUR. 2d *Conflicts of Law* § 19 (1979).
83. H.C. REP. No. 95, 95th Cong., 2nd Sess. 7, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 9000.
84. That clause read: "If at any time . . . the Federal Power Commission . . . shall . . . prescribe or approve a ceiling price or prices, however determined, which is generally applicable to gas being sold from the area in which the gas subject hereto is sold, which . . . is higher than the then applicable price [under the contract], the price for gas sold hereunder shall be increased to equal such higher price. . . ." Amoco Production Co. v. Stauffer Chemical Co. of Wyoming, *supra* note 46, at 464.
85. *Id.* at 468 (citations omitted) (emphasis added).
86. Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 636. The district court also stated that *Stauffer* differed factually from this case, but did not elaborate upon this point. *Id.* Perhaps the Court had in mind that in *Stauffer* there was no public utility involved. If this is the distinguishing feature of *Stauffer* in the court's analysis, such a determination would correspond to the previously discussed implicit holdings of the court on unconscionability which tend to place the public utility in a favored position in negotiations with private parties.

contrary, however, the public policy issue was discussed by both parties to the suit in their answer briefs.[87] *Stauffer* appears to be the clearest statement of Wyoming's public policy on this issue. Pursuant to *Erie R.R. Co. v. Tompkins,*[88] its precedent demands considerable deference. In sum, the district court's general attack on indefinite price escalator clauses rest on relatively limited and dated expressions of public policy. Especially in the light of *Stauffer,* the court's analysis of this issue does not provide clear and convincing support for a conclusion that clause 6(b) was contrary to public policy.

FPC Pricing Policy and the Effect of Clause 6(b)

Beginning in 1960, the FPC introduced "vintaging" concepts into its pricing policies. "Vintaging" referred to the age of the gas under contract; higher prices were allowed for "new" gas than for "old" gas because of the higher costs associated with producing new gas. Additionally, when the FPC adopted its national rate policy in 1972, small producers were allowed higher prices than large producers to encourage "wildcat" exploration. Thus, the "new" vintage of gas and the small size of the producer constituted two conditions precedent to the collection of the highest rates set by the FPC. (*See* Background).

The district court pointed out the fact that the gas involved under this contract was not "new" gas, nor were the producers "small" under FPC definitions.[89] Nevertheless, the producers were demanding rates applicable to new gas produced by small producers through clause 6(b) which set the contract price at the highest price being received by *any* Wyoming producer in interstate commerce. The court concluded that allowing the producers to collect these high prices for natural gas without fulfilling the conditions precedent required for collection in interstate sales by the FPC would violate public policy.[90]

Although the producer's demands may be criticized on this point for lacking public spiritedness, the court cited scant

87. *See* Amoco Brief, *supra* note 6, at Appendix.
88. 304 U.S. 64 (1938).
89. Kerr-McGee Corp. v. Northern Utilities, Inc., *supra* note 1, at 635.
90. *Id.*

authority for declaring these demands illegal.[91] Again, FPC pricing policies are relevant in determining what public policy may be in intrastate sales, but the states are the ultimate policy makers in this arena. Again, the Wyoming Supreme Court appears to have set this policy in *Stauffer*. In *Stauffer*, the court held that:

> the parties would have inserted such words in the contract if they intended the sale of gas to be subject to vintaging . . . vintaging is a form of control utilized by the FPC, and application of it to the contract price can be said to be contrary to the overall intention of the parties as expressed in the contract. . . .[92]

The court concluded: "it is a fundamental principle that a court may not make a new contract for the parties or rewrite their contract under the guise of construction. . . ."[93] *Stauffer* arguably stands for the proposition that the operation of indefinite price escalator clauses without reference to FPC "vintaging" requirements is not contrary to Wyoming public policy.

Significantly, a recent Fifth Circuit decision indicates that this operation may not be contrary to *United States* public policy expressed under the NGPA.[94] Observing that the NGPA placed limits on the operation of indefinite price escalator clauses in only four situations—none of which apply in this case[95]—the court held that escalator clauses are enforceable and may otherwise operate according to their terms without reference to vintaging.[96]

The above discussion suggests that the district court's invalidation of clause 6(b) on public policy grounds rests on a determination of public policy by the court which is open to disagreement. In the absence of statutes and binding judicial rulings in a particular area, determining public policy can be a

91. Such authority might be found by reference again to a "special or fiduciary" relationship between Northern and the producers; perhaps this idea also influenced the court at this point in its opinion.
92. Amoco Production Co. v. Stauffer Chemical Co. of Wyoming, *supra* note 46, at 467.
93. *Id.*
94. Pennzoil Co. v. Federal Energy Regulatory Commission, 645 F.2d 360 (5th Cir. 1981).
95. Under the NGPA, certain "high cost" gas prices (e.g., deep well and "stripper well" gas prices) will not trigger escalation provisions in other contracts. *See* 15 U.S.C. § 3315(3)(D) (Supp. III 1979).
96. Pennzoil Co. v. Federal Energy Regulatory Commission, *supra* note 94, at 378.

very difficult and subjective process. Because of the lack of clarity of public policy in these instances, courts should hesitate from using public policy as a tool of invalidation of contractual agreements.[97] As one court has stated, public policy invalidation "is a very unruly horse, and when you once get astride it you never know where it will carry you."[98]

CONCLUSION

The district court's decision in *Kerr-McGee Corp. v. Northern Utilities, Inc.* ultimately protects the consumer's interest in paying a "fair" price for natural gas. What a "fair" price for natural gas is has been the subject of much disagreement, especially in the last decade. The court, however, has determined that dramatic increases tied to indefinite price escalation clauses can be unfair to the consumer. Certainly, many would agree with this point of view. As has been discussed, however, "fairness" must be determined within the context of the current energy environment. In many ways, the NGPA was an attempt to establish fair prices in the light of the changes of the seventies; under the NGPA fair prices were determined not only by considering the impact upon the consumer, but also by considering the impact on supply and conservation.

The district court's decision in this case indicates that the judicial branch of government will continue to play a part in determining the contours of the natural gas policy of the United States. Those engaged in contract negotiations in the natural gas area should be wary of looking exclusively to the NGPA for guidance. Judicial construction of agreements in this area will continue to warrant special consideration in contracting.[99]

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97. *See* WILLISTON, 14 CONTRACTS, *supra* note 68, at § 1630.
98. *Id.* § 1629 (*quoting* Tracey v. Franklin, 30 Del. Ch. 407, 61 A.2d 780 (1948), *aff'd*, 31 Del. Ch. 477, 67 A.2d 56 (1949)).
99. This case was argued on appeal before the 10th Circuit on September 30, 1981.