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THE TAKE-OR-PAY WARS: A CAUTIONARY ANALYSIS FOR THE FUTURE*

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"Those who cannot remember the past are condemned to repeat it."¹

"Experience enables you to recognize a mistake when you make it again."²

I. INTRODUCTION

The first generation of take-or-pay battles—those between the natural gas producers and pipeline companies ("pipelines")—is subsiding.³

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‡ The contract provisions throughout this paper are intended only to stimulate discussion and analysis.

1. 1 GEORGE SANTAYANA, *THE LIFE OF REASON* 284 (2d ed. 1922).

2. LAURENCE J. PETER, *PETER'S QUOTATIONS* 174 (1979) (quoting Franklin P. Jones).

3. This paper will avoid extensive citations and will, for the most part, not cite authorities discussed in earlier articles. For those interested in more extensive citations on gas contract litigation than those listed in this paper, see J. Michael Medina, *Take-or-Pay Oklahoma Style*, 60 OKLA. B.J. 705 (1989); J. Michael Medina, *The Take-or-Pay Wars: A Further Status Report*, 41 OKLA. L. REV. 381 (1988) [hereinafter Medina, *A Further Status Report*]; J. Michael Medina, *A Report from the Battle Zone: The Take or Pay Wars*, 58 OKLA. B.J. 2554 (1987) [hereinafter Medina, *A Report from the Battle Zone*], reprinted in 24 PUB. LAND & RESOURCES L. DIG. 268 (1987); and J. Michael Medina et al., *Take or Litigate: Enforcing the Plain Meaning of the Take-or-Pay Clause in Natural Gas Contracts*, 40 ARK. L. REV. 185 (1986) [hereinafter Medina et al., *Take or Litigate*], reprinted in 24 PUB. LAND & RESOURCES L. DIG. 192 (1987). An extensive bibliography of materials on take-or-pay contracts and litigation can be found in 8 HOWARD R. WILLIAMS & CHARLES J. MEYERS, *OIL AND GAS LAW, MANUAL OF OIL AND GAS TERMS* 1233-44 (1991).

While major pieces of producer-pipeline litigation remain in the courts,⁴ attention has now turned to two new fronts: producer-lessor royalty disputes⁵ and state severance tax controversies.⁶ At this juncture, it is appropriate to look at past take-or-pay disputes and extract lessons to guide future gas purchase contracting. Past litigation shows that courts will not grant relief simply because a party enters into a bad bargain.⁷ There

4. See *Columbia Gas Transmission Corp. v. Koch Indus.*, No. 91-174 (E.D. La. April 22, 1991) (holding "banked gas" of underproduced party covered by take-or-pay obligations); *Pelto Oil Co. v. CSX Oil & Gas Corp.*, 804 S.W.2d 583 (Tex. App.—Houston [1st Dist.] 1991, writ denied). For an analysis of various gas balancing problems, see Wade A. Hoefling, *Gas Balancing Problems in a Deregulated Market: Changes and Possible Solutions Under Oklahoma Law*, 25 TULSA L.J. 63 (1989); and Patrick H. Martin, *The Gas Balancing Agreement: What, When, Why, and How*, 36 ROCKY MTN. MIN. L. INST. § 13.01 (1990). For an analysis of disproportionate gas sales by a working interest owner and its relation to gas balancing, see David E. Pierce, *The Law of Disproportionate Gas Sales*, 26 TULSA L.J. 135 (1990).

5. See, e.g., *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988); *Frey v. Amoco Prod. Co.*, 708 F. Supp. 783 (E.D. La. 1989), *rev'd*, 943 F.2d 578 (5th Cir. 1991); *Mandell v. Hamman Oil & Ref. Co.*, No. 01-90-00950-CV, 1991 WL 248676 (Tex. App.—Houston [1st Dist.] Nov. 27, 1991, no writ); *Killam Oil Co. v. Bruni*, 806 S.W.2d 264 (Tex. App.—San Antonio 1991, writ denied); *Hamman Oil & Ref. Co. v. Mandell*, No. 87-41636 (Tex. Dist. Ct. Harris County June 22, 1990); *State v. Pennzoil Co.*, 752 P.2d 975 (Wyo. 1988); cf. *Finkelstein v. Transamerican Natural Gas Corp. (In re Transamerican Natural Gas Corp.)*, 127 B.R. 800 (S.D. Tex. 1991) (remanding to state court a dispute over a take-or-pay settlement). For recent discussions on the issue of royalties, see Cyril A. Fox, jr., *Rights of a Lessor in Payments Received by a Producer from "Buydowns" or "Buyouts" of Long-Term Contracts*, 10 E. MIN. L. INST. § 1.01 (1989); William H. White, *The Right to Recover Royalties on Natural Gas Take-or-Pay Settlements*, 41 OKLA. L. REV. 663 (1988); Kirk J. Bily, Comment, *Royalty on Take-or-Pay Payments and Related Consideration Accruing to Producers*, 27 HOUS. L. REV. 105 (1990); and James E. Prince, Note, *Production, Production, What is Production?* *Diamond Shamrock v. Hodel*, 1989 B.Y.U. L. REV. 1333.

6. See Elizabeth K. Brown & Frank H. McGregor, *Fallout from the Take-or-Pay Wars: Gross Production Tax on Proceeds Received in Settlement of Take-or-Pay Litigation*, 43 OKLA. L. REV. 457 (1990); Michael P. Pearson & Richard D. Watt, *To Share or Not to Share: Royalty Obligations Arising out of Take-or-Pay or Similar Gas Contract Litigation*, 42 INST. ON OIL & GAS L. & TAX'N ¶ 14.01, ¶ 14.03[2][c][ii] (1991); cf. John S. Lowe, *Severance Taxes as an Issue of Energy Sectionalism*, 5 ENERGY L.J. 357 (1984).

7. Courts have consistently refused to save a party from a bad bargain. See, e.g., *United States v. Bethlehem Steel Corp.*, 315 U.S. 289, 301 (1942) (holding coercion was not established even though government lacked bargaining strength because of its great need for warships); *Aircraft Assocs. & Mfg. Co. v. United States*, 357 F.2d 373, 378 (Ct. Cl. 1966) ("Economic duress may not be implied merely from the making of a hard bargain."); *Fruhauf Southwest Garment Co. v. United States*, 111 F. Supp. 945, 951 (Ct. Cl. 1953) ("In order to substantiate the allegation of economic duress . . . the plaintiff must go beyond the mere showing of a reluctance to accept and of financial embarrassment."); *LaBeach v. Beatrice Foods Co.*, 461 F. Supp. 152 (S.D.N.Y. 1978) (holding economic duress did not vitiate release of monetary claims by discharged employee despite disparity of bargaining power); *W.J. Seufert Land Co. v. Greenfield*, 496 P.2d 197, 201 (Or. 1972) (holding contract provision that was harsh on one party and not the other was not against public policy); *Horgan v. Industrial Design Corp.*, 657 P.2d 751, 754 (Utah 1982) (holding that a bad bargain is not a basis on which to invalidate an agreement).

Judicial unwillingness to interfere with a bad bargain is demonstrated by almost universal rejection of the pipeline defenses of unconscionability, impracticability, public policy, and mistake. In a similar vein, courts seldom invalidate settlement agreements. E.g., *Bryant v. Transcontinental Gas Pipe Line Corp.*, No. B14-90-00590-CV, 1991 WL 114477 (Tex. App.—Houston [14th Dist.] June 27, 1991, writ requested) (affirming order that enforced settlement agreements against producers);

is no indication that this basic precept will change for future litigants. To date, producers have prevailed in most take-or-pay disputes⁸ because the pipelines, who drafted most purchase contracts, failed to protect themselves, and not because of superior producer draftsmanship. The future may not be so kind to the producers.

This paper first summarizes past producer-pipeline litigation wars. Second, the successes and failures of battle strategies of both producers and pipelines are examined. Finally, based upon the lessons learned from past disputes, the paper analyzes specific clauses in gas purchase contracts. The most important lesson learned from past take-or-pay disputes is that courts will strictly enforce the terms of a gas purchase contract.⁹ Consequently, success in the future generations of take-or-pay wars will depend upon carefully drafted contracts.

see J. Michael Medina, *Economic Duress as a Means of Avoiding Settlement Agreements in Oklahoma*, 15 OKLA. CITY U. L. REV. 255 (1990). Given their widely recognized validity, settlement agreements must be carefully drafted. See Medina et al., *Take or Litigate*, *supra* note 3, at 253-55, reprinted in 24 PUB. LAND & RESOURCES L. DIG. at 260-62.

8. Tennessee Gas Pipeline Co., 54 F.E.R.C. ¶ 61,095 (1991).

9. See David E. Pierce, *Developments in Nonregulatory Oil and Gas Law: Relationships, Contracts, Torts, and the Basics*, 41 INST. ON OIL & GAS L. & TAX'N § 1.01, § 1.03[2] (1990) ("[I]t is not surprising to find language, conceived during another contracting era, which attempts to address the parties' rights under weak market conditions. Although such language may not have been the focus of negotiations leading to the contract, it is, nevertheless, equally enforceable."). This literal approach worked mostly in the past to benefit producers. *E.g.*, *Wagner & Brown II v. ONEOK, Inc.*, No. CIV-89-943-R (W.D. Okla. Mar. 29, 1990) (striking force majeure because pipeline sent notice to operator, not seller as required by the contract); *R.J.B. Gas Pipeline Co. v. Colorado Interstate Gas Co.*, 813 P.2d 14, 24-25 (Okla. Ct. App. 1990) (strictly construing recoupment provisions and disallowing the pipeline to offset breach of contract damages with the value of unrecouped gas). Moreover, courts refused to allow pipeline companies to stand behind standard gas contract provisions for protection against events not originally contemplated by the provisions. See, *e.g.*, *Mustang Prod. Co. v. Delhi Gas Pipeline Co.*, No. CIV-83-1667-BT, slip op. at 9-10 (W.D. Okla. Nov. 9, 1983) (holding that economic disconnect clause was intended to permit a pipeline to disconnect gas wells that are uneconomical due to low production, not low market prices); *cf.* *Coastal Oil & Gas Corp. v. FERC*, 782 F.2d 1249, 1253 (5th Cir. 1986) (holding economic connection clause does not limit dedication to interstate commerce; "Coastal's internal memoranda indicate that this interpretation was a new theory dreamed up by its counsel as recently as 1980").

Producers also lost cases because of the courts' insistence on strict performance of contract terms. See, *e.g.*, *Dyco Petroleum Corp. v. ANR Pipeline Co.*, No. 86-C-1097-C (N.D. Okla. Oct. 27, 1989) (denying producer's claims because it failed to provide notice of drainage damage to the pipeline company as required by the contract); *Prima Energy Corp. v. Panhandle E. Pipe Line Co.*, No. 89-CV-331 (Colo. Dist. Ct. Weld County Oct. 5, 1990) (enforcing assignment notice clause); *Williams Natural Gas Co. v. Amoco Prod. Co.*, No. 11040, 1991 WL 58387 (Del. Ch. Apr. 16, 1991) (enforcing ratable take clause to relieve pipeline of take-or-pay obligation when pipeline's loss of other contracts in area caused it to take no gas from the seller); *Lone Star Gas Co. v. G.S.G. Royalty Corp.*, 757 S.W.2d 457, 459-60 (Tex. App.—Dallas 1988, no writ) (construing "deemed produced" clause strictly in favor of pipeline); *Lone Star Gas Co. v. Lively Energy & Dev. Corp.*, No. 04-87-00261-CV, slip op. at 3-11 (Tex. App.—San Antonio Oct. 11, 1989, no writ) (reversing lower court award in favor of producer because pipeline's take-or-pay clause obligation was conditioned on ownership and producer did not have an ownership interest).

II. EVOLUTION OF THE NATURAL GAS CONTRACT

Prior to 1960, fluctuations in the demand for natural gas created financial hardships for natural gas producers. The demand for natural gas increases substantially during winter months because natural gas is used for commercial and residential heating. To handle winter peaks, pipelines acquired an overabundance of production capacity from producers. In addition, pipelines insisted that producers exclusively dedicate particular wells or reservoirs to the pipeline in the gas purchase contract. Pipelines, however, were under no obligation to purchase gas from the producers. As a result, during periods of low demand for natural gas pipelines purchased less than full production from producers, if any gas at all. Producers, unable to sell the gas to other purchasers because of the exclusive dedication clause, suffered from lost gas sales revenue. In many cases, producers were unable to recover drilling, exploration and operation costs.

Producers sought refuge in the take-or-pay clause. The provision required the pipeline to purchase a minimum quantity of gas each period, regardless of whether the pipeline took the minimum quantity of gas. In the event the pipeline paid for more gas than it took, it acquired the right to take that gas in the future at no cost. The take-or-pay clause assured the producer of continued revenue, regardless of the market demand for gas.

Historically, the pipeline industry was rather cavalier toward the take-or-pay clause. During the 1970s and early 1980s, pipelines routinely included the clause in natural gas contracts. Such clauses were insignificant to the pipeline when considered in the overall context of the contract because demand for natural gas had historically exceeded the supply.

The producer was not as ambivalent toward inclusion of a take-or-pay clause in the gas purchase contract. The producer always regarded the take-or-pay clause as a necessity because a gas well is worthless if no gas is sold.¹⁰

Take-or-pay clauses, however, are more than just bargaining chips in negotiations for new gas reserves. They provide reasonable assurance to the producer of a certain minimum income stream from a well in cases where the producer is asked to make a long-term commitment of

10. Richard J. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345, 354-55 (1983); Vernon M. Turner, *Natural Gas—Impact of Deregulation or Reregulation on Sales Contracts*, 29 ROCKY MTN. MIN. L. INST. 501, 522-23 (1983).

its gas to a single buyer. Having dedicated its gas under such a contract, it is of critical importance to the producer to have some assurance of recovering its substantial investment in the wells involved. Indeed, without a guaranteed minimum cash flow, producers are usually unwilling to commit their reserves to a single purchaser on a long-term basis.¹¹

By 1970, take-or-pay clauses became a standard part of the natural gas contract; producers absolutely required the clause, and pipelines acquiesced because of the demand for natural gas.¹²

During the 1980s, falling natural gas prices caused pipelines to regret inclusion of the take-or-pay clause in long-term natural gas contracts. After the decline, the market price for gas was substantially less than the fixed price in the contract in most instances. The price discrepancy forced pipelines to choose between taking gas at the contract price and reselling at the lower market price or paying for gas and taking it later, with the hope that the market price would increase in the future. As gas prices stabilized at less than long-term contract prices, pipelines realized that performance under the old contracts would be unprofitable.¹³ As a result, many pipelines attempted to minimize their liability through negotiation and modification of the contracts, settlements and litigation. These endeavors, however, resulted in little success for the pipelines.

11. El Paso Natural Gas Co., 40 F.E.R.C. ¶ 63,047 (1987), *aff'd*, 42 F.E.R.C. ¶ 61,024 (1988); see also Susan Zachos, Comment, *Gas Purchase Contracts: Equitable Remedies for Breach*, 24 HOUS. L. REV. 991, 993-95 (1987); Order No. 500-K, Natural Gas Pipelines After Partial Wellhead Decontrol, et al., III F.E.R.C. Stats. & Regs. ¶ 30,917, at 30,090 (Apr. 4, 1991) ("The whole purpose of the take-or-pay clause was to ensure the producer a minimum level of income by requiring the pipeline either to purchase and pay for the gas or, if it did not purchase the gas, at least pay for it."); cf. Williston Basin Interstate Pipeline Co. v. FERC, 931 F.2d 948 (D.C. Cir. 1991) (producer's leverage with pipeline diminishes as field diminishes).

12. Significant bargaining, however, continued in the industry. See Harry G. Broadman, *Elements of Market Power in the Natural Gas Pipeline Industry*, ENERGY J., Jan. 1986, at 119; William B. Cassin, *Gas Purchase Contracts—Enticing a Shy Genie from an Invisible Lamp*, 25 INST. ON OIL & GAS L. & TAX'N 27, 30-31 (1974); J. Harold Mulherin, *Complexity in Long-Term Contracts: An Analysis of Natural Gas Contractual Provisions*, 2 J.L. ECON. & ORGAN. 105 (1986); see also Scott E. Masten & Keith J. Crocker, *Efficient Adaptation in Long-Term Contracts: Take-or-Pay Provisions for Natural Gas*, 75 AM. ECON. REV. 1083 (1985).

13. Pipelines bear the risk of a decreasing market price in a long-term gas contract. E.g., Prenalta Corp. v. Colorado Interstate Gas Co., 944 F.2d 677, 680, 688 (10th Cir. 1991); Universal Resources Corp. v. Panhandle E. Pipe Line Co., 813 F.2d 77, 80 (5th Cir. 1987); United States v. Panhandle E. Corp., 693 F. Supp. 88, 98 (D. Del. 1988), *aff'd*, 868 F.2d 1363 (3d Cir. 1989); *R.J.B. Gas Pipeline Co.*, 813 P.2d at 25 ("[T]ake-or-pay provisions . . . are deemed to [allocate] the risks [and] must be strictly construed."); Valero Transmission Co. v. Mitchell Energy Corp., 743 S.W.2d 658, 663 (Tex. App.—Houston [1st Dist.] 1987, no writ) ("[T]he uncertainty of future market prices is often the motivation for entering into a long-term contract. The primary purpose of a price agreement is to fix the price and consequently avoid the risk of price fluctuation.").

Despite pipelines' harsh experiences, the long-term contract remains an important part of the natural gas industry. Although producers and pipelines have experimented with other arrangements,¹⁴ long-term contracts remain mutually beneficial for both parties.¹⁵

III. THE TAKE-OR-PAY CLAUSE

A typical take-or-pay clause specifies an annual minimum quantity of gas for which the producer will be compensated. The minimum quantity is typically a fraction of either the deliverability of the gas well or the underground gas reserves dedicated to the contract.¹⁶ In the event the purchaser fails to take the minimum annual quantity, the purchaser must pay a "deficiency payment." This payment is equivalent to the value of

14. With the gas surplus of 1982 came a radical shift in the natural gas industry. Short-term ("spot market") contracts emerged as the standard industry practice. In contrast with previous long-term contracts, newer long-term contracts contained a "take-or-release" in lieu of a take-or-pay clause. A take-or-release clause is one "which gives the seller the right to terminate the contract if the buyer does not take minimum amounts of gas." WILLIAMS & MEYERS, *supra* note 3, at 1246.

15. With deregulation and the shifting roles of pipelines, new opportunities for contracting arise. However, the same desire for market stability that led to long-term contracts in the first place will continue to encourage long-term contracts in the future. Equitrans, Inc., 52 F.E.R.C. ¶ 61,228, at 61,814-15 (1990) (discussing need to provide incentives functionally similar to take-or-pay clauses to induce producers to restructure relationship with purchasers, and noting need of producers to have revenue certainty); R. Glenn Hubbard & Robert J. Weiner, *Efficient Contracting and Market Power: Evidence from the U.S. Natural Gas Industry*, 34 J.L. ECON. 25, 64-65 (1991) (predicting that economics and market efficiency will lead to reemergence of long-term contracting).

For an analysis of the benefits of long-term contracting, see Harry C. Broadman & Michael A. Toman, *Non-Price Provisions in Long Term Natural Gas Contracts*, 62 LAND ECON. 111 (1986); Michael E. Canes & Donald A. Norman, *Long-Term Contracts and Market Forces in the Natural Gas Market*, 10 J. ENERGY & DEV. 73 (1984); Thomas G. Johnson, *Natural Gas Sales Contracts*, 34 INST. ON OIL & GAS L. & TAX'N 83, 108-09 (1983); Norris C. McGowen, *Natural Gas—Its Present and Future*, 4 INST. ON OIL & GAS L. & TAX'N 133, 142 (1953); Ernst-Joachim Mestmäcker, *Natural Gas in the European Internal Market: A Comparative Analysis of Common Carriage and Price Transparency*, 11 MICH. J. INT'L L. 691 (1990); Pierce, *supra* note 10, at 356-57, 383-84.

For recent articles on natural gas contracts, see 4 W.L. SUMMERS, *THE LAW OF OIL AND GAS* § 762 (Supp. 1991); Joe Caggiano, *Understanding Natural Gas Contracts*, 38 OIL & GAS TAX. Q. 267 (1989); William H. Penniman & Gail S. Gilman, *Negotiating a Direct Gas Purchase Contract for the End User*, 10 E. MIN. L. INST. § 17.01 (1989); Carroll L. Gilliam, *Gas Sales Contracts in a Changing Market*, 37 INST. ON OIL & GAS L. & TAX'N § 6.01 (1986); J. Clayton La Grone, *The Supply Side of Cogeneration*, 36 ROCKY MTN. MIN. L. INST. § 14.01 (1990); John S. Lowe, *A New Generation of Gas Contracts*, 8 CORP. COUNSEL REV. 1 (1989); Masten & Crocker, *supra* note 12; Arthur J. Wright, *Contractual Issues in Marketing Natural Gas in the 1990's*, 36 ROCKY MTN. MIN. L. INST. § 16.01 (1990); Danton B. Rice & Michael A. Schlueter, Note, *Deregulation and Natural Gas Purchase Contracts: Examination Through Neoclassical and Relational Contract Theories*, 25 WASHBURN L.J. 43, 46-49 (1985). See also Apache Gas Prods. Corp. v. Oklahoma Tax Comm'n, 509 P.2d 109, 112-13 (Okla. 1973) (recognizing necessity for long-term contracts in natural gas industry).

16. For example, a minimum quantity could be "seventy-five percent (75%) of the Delivery Capacity of each well." See Medina et al., *Take or Litigate*, *supra* note 3, at 187, reprinted in 24 PUB. LAND & RESOURCES L. DIG. at 194. For a recent discussion of the take-or-pay clause, see Prenalata Corp. v. Colorado Interstate Gas Co., 944 F.2d 677, 679-81 (10th Cir. 1991).

the difference between the minimum annual quantity and the amount taken during the year.

Another traditional term in the contract between producer and pipeline is the recoupment provision. The recoupment provision of the take-or-pay clause allows the buyer to take, without payment, a quantity of gas valued at the amount of the deficiency payments paid in previous periods. Three concepts govern recoupment. First, a buyer may recoup only after taking the minimum quantity for the current year.¹⁷ Second, the recoupment quantity is determined by the contract price of the gas at the time of recoupment. Third, the buyer's right to recoup may be limited in time by law or contract. In the event the buyer does not recoup within the time limit, the buyer forfeits the right to recoup and the seller is allowed to keep the deficiency payments. Some contracts allow the buyer to recoup during the life of the contract. Others require the seller to return any outstanding deficiency payments at the end of the contract.

IV. PRODUCER'S HISTORICAL REMEDIES

The producer's primary remedy to enforce its rights under the contract was a suit to collect past due deficiency payments. Typically, damages equaled the value of the difference between the minimum quantity and the quantity taken. For example, if the pipeline was required to purchase 750,000 cubic feet ("cf") of natural gas per year and only purchased 50,000 cf, the pipeline's deficiency would be 700,000 cf. At a contract price of \$3.00 per 1000 cf, the pipeline would owe the producer a deficiency payment of \$2,100 for that accounting year.

Pipelines have disputed this method of calculating damages, citing UCC remedy provisions. Section 2-708(1) provides a "measure of damages for non-acceptance or repudiation by the buyer [equal to the] difference between the market price at the time and place for tender and the unpaid contract price together with . . . incidental damages."¹⁸ Pipelines argued that under the section 2-708(1) damage formula producers are required to deduct the market price of the gas at the time of breach from the contract price.¹⁹

17. *E.g.*, *Sid Richardson Carbon & Gasoline Co. v. InterNorth, Inc.* 595 F. Supp. 497, 500 (N.D. Tex. 1984).

18. U.C.C. § 2-708(1), 1B U.L.A. 265 (1989).

19. Gas purchase contracts are governed by Article 2 of the Uniform Commercial Code. *See Manchester Pipeline Corp. v. Peoples Natural Gas Co.*, 862 F.2d 1439, 1444-46 (10th Cir. 1988) (applying Oklahoma's version of UCC remedies to breach of gas contract); *Kerr-McGee Corp. v. Northern Utils., Inc.*, 673 F.2d 323, 328-30 (10th Cir.) (applying UCC unconscionability provision to gas contract), *cert. denied*, 459 U.S. 989 (1982); *Pennzoil Co. v. FERC*, 645 F.2d 360, 388 (5th

