No. 83, Original

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1978

STATE OF MARYLAND,
STATE OF ILLINOIS,
STATE OF INDIANA,
COMMONWEALTH OF MASSACHUSETTS,
STATE OF MICHIGAN,
STATE OF NEW YORK,
STATE OF RHODE ISLAND AND
PROVIDENCE PLANTATIONS,
STATE OF WISCONSIN,

*Plaintiffs,*

v.

STATE OF LOUISIANA,

*Defendant.*

ON REPORT OF THE SPECIAL MASTER DATED SEPTEMBER 15, 1980

## EXCEPTIONS OF THE PLAINTIFF STATES AND BRIEF IN SUPPORT OF EXCEPTIONS

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November 14, 1980

The Daily Record Co., Baltimore, MD 21202

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ON REPORT OF THE SPECIAL MASTER DATED SEPTEMBER 15, 1980

## EXCEPTIONS OF THE PLAINTIFF STATES

The State of Maryland, the State of Illinois, the State of Indiana, the Commonwealth of Massachusetts, the State of Michigan, the State of New York, the State of Rhode Island and Providence Plantations, and the State of Wisconsin ("the plaintiff states"), by their undersigned attorneys, except to the Report of the Special Master dated September 15, 1980, and ordered filed October 6, 1980, in the following respects:

### Exception No. I

The plaintiff states except to the Special Master's misstatement of the applicable Supremacy Clause test, Report at 21, 27, and his failure to conclude that the First Use Tax is in conflict with and preempted by the Natural Gas Act and the Natural Gas Policy Act. Report at 21-22.

**Exception No. II**

The plaintiff states except to the Special Master's finding that the "ongoing dispute between the parties" about the "processing," Report at 28; FERC's ability to make adjustments for the First Use Tax, Report at 21, 29; the Commission's "final decision as to the allotment of the tax," Report at 27-28; and the degree to which the tax affects FERC's comprehensive regulatory powers, Report at 27, are relevant to the determination of the plaintiffs' claim that under the Supremacy Clause the First Use Tax is in conflict with and preempted by the Natural Gas Act and the Natural Gas Policy Act.

**Exception No. III**

The plaintiff states except to the Special Master's apparent conclusion that the First Use Tax does not conflict with and is not preempted by the Outer Continental Shelf Lands Act. Report at 29-30.

**Exception No. IV**

The plaintiff states except to the Special Master's refusal to decide that the First Use Tax discriminates on its face against interstate commerce. Report at 34-35.

**Exception No. V**

The plaintiff states except to the Special Master's finding that "what adjustments can be made in the base prices, and what allowances can be made between buyers and sellers which might reduce or eliminate any disadvantage of one over the other," Report at 35; and "the very real dispute among the parties" about "processing," Report at 27, are relevant to the determination of the plaintiffs' claim that the First Use Tax discriminates against interstate commerce and therefore violates the Commerce Clause; and, in this regard, the plaintiff states further except to the Special Master's suggestion that the First Use Tax, which falls almost exclusively on federal OCS gas, would not discriminate against interstate commerce if it were, as the Special Master erroneously suggests it could be, a "'compensating' tax intended to complement the State severance tax," which applies only to Louisiana gas. Report at 35.

## Exception No. VI

The plaintiff states except to the Special Master's conclusion that "the [fair] apportionment requirement has [no] application here, unless the tax is so large as to put a barrier in the path of interstate commerce." Report at 36.

## Exception No. VII

The plaintiff states except to the Special Master's recommendation that their motion for judgment on the pleadings be denied at this time and to each and every reason assigned by the Special Master for this recommendation. Report at 38.

Respectfully submitted,

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ON REPORT OF THE SPECIAL MASTER DATED SEPTEMBER 15, 1980

## BRIEF IN SUPPORT OF THE EXCEPTIONS OF THE PLAINTIFF STATES

## STATEMENT

### I. History of the Proceedings

On March 29, 1979, Maryland, Illinois, Indiana, Massachusetts, Michigan, New York, Rhode Island, and Wisconsin ("the plaintiff states") filed their motion for leave to file a complaint and the proposed complaint, which invoked the original jurisdiction of this Court to contest the constitutionality of the Louisiana First Use Tax on Natural Gas. Alleging great harm to their sovereign and quasi-sovereign interests, the plaintiff states challenged the tax on Supremacy Clause, Commerce Clause, Contracts Clause, and Import-Export Clause grounds, as well as under the Equal Protection Clause of the Fourteenth Amendment. The key components of the plaintiffs' Supremacy Clause challenge emphasized the tax's preemption by and conflict with the Natural Gas Act, the Natural Gas Policy Act, the Outer Continental Shelf Lands Act, and the Coastal Zone Management Act. The plaintiffs alleged that the First Use Tax violated the Commerce Clause, among other reasons, because it facially discriminated against interstate commerce and was not fairly apportioned.

Rejecting Louisiana's contention, in its brief in opposition, that this case was not appropriate for the exercise of original jurisdiction, this Court, on June 18, 1979, granted the plaintiffs' motion for leave to file the complaint. On August 17, 1979, the defendant filed its answer, asserting the validity of the tax. The plaintiffs filed a motion for judgment on the pleadings on September 18, 1979, which was supported by various *amici curiae,* including the United States and the Federal Energy Regulatory Commission, and seventeen natural gas pipeline companies that were prospective intervenors in the case. The motion of the plaintiff states pressed for judgment on the Supremacy Clause issues and the facial discrimination and fair apportionment Commerce Clause issues. Louisiana then moved to dismiss the complaint on October 22, 1979, on the same grounds asserted in its original brief in opposition for denying leave to file the complaint.

On March 3, 1980, this Court appointed John F. Davis, Esquire, as Special Master and referred to him all of the pending motions except Louisiana's for dismissal of the complaint. Following a hearing on March 21, 1980, at which the plaintiffs vigorously contended that the case was ripe for judgment on the pleadings and pressed for decision on the motion, and the defendant sought protracted evidentiary hearings, the Special Master required Louisiana to file a proffer specifying the factual matters it believed justified evidentiary hearings. Louisiana responded with a 116-page submission largely concerned with factual averments arguably relevant only to constitutional claims not pressed in the plaintiffs' motion.[1] On June 19, 1980, the Special Master heard argument on the motion for judgment on the pleadings and on the defendant's motion to dismiss. The Report of the Special Master recommending denial of the motion to dismiss and denial without prejudice of the motion for judgment on the pleadings is dated September 15, 1980, and was ordered filed by this Court on October 6, 1980.

## II. History and Operation of the First Use Tax

The First Use Tax, effective April 1, 1979, imposed a tax of seven cents per thousand cubic feet (Mcf) upon the first occurrence of any "use" of natural gas within Louisiana not subject to state severance taxes. La. Rev. Stat. Ann. § 47:1301-1307 (West Supp. 1980). "Use" is defined as:

> the sale; the transportation in the state to the point of delivery at the inlet of any processing plant; the transportation in the state of unprocessed gas to the point of delivery at the inlet of any measurement or storage facility; transfer of possession or relinquishment of control at a delivery point in the state;

[1] Only thirteen pages of the proffer purported to concern issues raised in the plaintiffs' motion and much of this was devoted to asserted legal premises and legal argument. *See* Reply of the Plaintiff States to the Defendant's Proffer of Proof. In this reply, the plaintiffs also contended that on the basis of Louisiana's admissions in the proffer and in light of legal principles recognized in this Court's natural gas decisions, judgment on the pleadings was particularly appropriate.

> processing for the extraction of liquefiable component products or waste materials; use in manufacturing; treatment; or other ascertainable action at a point within the state.

La. Rev. Stat. Ann. § 47:1302(8).[2] As the legislative history of the First Use Tax makes apparent and as the Special Master found to be undisputed, Report at 3-5, the tax is imposed on natural gas produced from federally owned submerged lands on the outer continental shelf (OCS) outside Louisiana's boundaries, and from federal enclaves within the state.

A variety of provisions ensure that the burden of the tax is not imposed on Louisiana citizens, businesses, or the producers of natural gas. The First Use Tax is not imposed on gas otherwise subject to a severance, production, or import tax levied by any state, territory, or the United States, La. Rev. Stat. Ann. § 47:1303, and because Louisiana levies a severance tax on all in-state production, La. Rev. Stat. Ann. § 47:633(g), the latter is not subject to the First Use Tax.

As a companion measure to the First Use Tax, the Louisiana legislature enacted a Severance Tax Credit that permits those few producers who might otherwise be liable for the First Use Tax on OCS gas to credit that liability, dollar-for-dollar, against their severance tax liability. La. Rev. Stat. Ann. § 47:647. According to the architect and chief proponent of the First Use Tax, in most cases the pipelines rather than the producers have become the contractual owners of the OCS gas by the time it arrives in Louisiana for processing. Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 3 (Testimony of Mr. Tauzin). However, "[i]n about 15% of the cases the producer is still the owner at the processing stage. In that event, in those cases there is a

[2] La. Rev. Stat. Ann. § 47:1303F provides that: "If any use as defined . . . and first occurring is determined not to be a constitutionally taxable incident, the tax shall be imposed upon the use first occurring thereafter."

separate bill which Representative LaBorde is author which will grant producers a tax credit against the severance taxes for any amount of this tax they could not pass on to the pipeline company." *Id.* at 3-4. The clear purpose of the severance tax credit measure is to benefit those who are producing OCS natural gas in the federal domain offshore Louisiana and who are also producing gas within the state and its waters in the natural gas-rich Southern Louisiana area. *See Mobil Oil Corp. v. FPC,* 417 U.S. 283, 293 (1974).

Exempted from the First Use Tax is natural gas consumed in processing and those products removed during that processing within the state. La. Rev. Stat. Ann. § 47:1303A.

> And it is important to know that 98 and a half percent of that product upon which we measure the tax is shipped out of state. Only about one and a half percent of that product remains as dry gas in Louisiana. There is a separate bill also authored by Mr. Bagert that deals with the impact of that one and a half percent.

Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 4 (Testimony of Mr. Tauzin).

Another companion measure to the First Use Tax grants a tax credit to utilities and other direct users of natural gas in the state who might otherwise be liable for the burden of the tax with respect to the minute amount of OCS gas that remains in Louisiana. La. Rev. Stat. Ann. § 47:11. Typically, producers of OCS gas retain the ownership of products removed in processing, such as butanes, propanes, and ethanes. *See* Report at 5. The Louisiana Senate committee considering the First Use Tax was told in 1978 that "[a]pproximately 5% of the product is removed in the processing stage as liquid-propane, butane, methanes and what have you. Additionally, you need to know that that particular amount, the 5% is exempted in the bill." Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 3 (Testimony of Mr. Tauzin). Thus, in-state processors and those in-state producers who also produce OCS gas are protected from the tax.

Finally, in a supreme effort to eliminate any possible impact on in-state interests and to "export the tax," in its totality, Hearings on H.B. 768, House Committee on Ways and Means (June 6, 1978) at 39 (Testimony of George Gibson), the statute characterizes the First Use Tax as a "cost associated with uses made by the owner in preparation of marketing of the natural gas" and abrogates any contract that shifts liability for the tax back to a producer by rendering unenforceable "[a]ny agreement or contract by which an owner of natural gas claims a right of reimbursement or refund of such taxes from any other party in interest, other than a producer of such natural gas." La. Rev. Stat. Ann. § 47:1303C. When a Louisiana legislator asked "What in the bill . . . will try to prevent the producer from having to pay these costs," the First Use Tax's chief proponent pointed to the contract abrogation feature of section 1303C. Hearings on H.B. 768, House Committee on Ways and Means Committee (June 6, 1978) at 6 (Colloquy between Messrs. Leach and Tauzin). Indeed, this provision was deemed by the sponsor as so "essential to the whole process," Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 5 (Testimony of Mr. Tauzin), that if the courts invalidated it and upheld such contracts, the whole First Use Tax would self-destruct. Act No. 294, § 4(2), 1978 La. Sess. Law Serv. 486 (West).

The verbatim legislative history of the 1978 hearings on the First Use Tax proposal is replete with colorful testimony that makes it obvious that the First Use Tax is "not just an ordinary little tax," Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June

26, 1978) at 10 (Testimony of Mr. Tauzin), but a tax that "*wants to hit only the easterners.*" Hearings on H.B. 768, House Committee on Wavs and Means (June 6, 1978) at 37 (Testimony of Ed Steimel) (emphasis added). Indeed, from the mouths of the framers of the First Use Tax and its companion measures, one learns that the legislative package was amended to "*guarantee against any impact upon producers and people in this state* who would otherwise possibly feel some impact from the imposition of the tax," Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 3 (Testimony of Mr. Tauzin) (emphasis added); that "[i]t is impossible for" them "to suffer," *Id.* at 4; and that "every possible concession" had been made to the producers. Hearings on H.B. 768, House Committee on Ways and Means (June 6, 1978) at 5 (Testimony of Mr. Tauzin). *See also* Hearings on H.B. 768, House Committee on Ways and Means (June 5, 1978) at 4 (Testimony of Mr. Bagert):

> We don't want to levy the first use tax and have it affect people and businesses in Louisiana. . . . As far as I'm concerned I don't want the first use tax if it's going to do that and that's why I initially authored this bill and then got together and worked it out with Billy [Tauzin].

The framers' desire, and the intention of the statute, to pass on the tax to the out-of-state consumers of natural gas is not disguised in the slightest. *See* Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 27 (Testimony of Mr. Tauzin) ("FERC is going to have to allow this particular tax to pass on through."); Hearings on H.B. 768, House Committee on Ways and Means (June 5, 1978) at 12 (Testimony of Mr. LaBorde) ("If the first use tax is passed, it's going to be a passed on tax, no question about it."). And they frankly admit that they broke the First Use Tax package into separate bills to create a veneer of constitutionality. Hearings on H.B. 768, House Committee on Ways and

Means (June 5, 1978) at 4 (Testimony of Mr. Tauzin) ("If you put the two together you've given the people who want to defeat it a chance to go to court and say look they've passed the act to just cover people outside Louisiana."); that one of their motives was to even the score for the actions of other states (e.g., the enactment of Montana's coal severance tax), Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 28 (Testimony of Mr. Tauzin) ("They've been doing it to us."); and that they expect to gain from the tax even if it is invalidated. Hearings on H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 6 (Testimony of Mr. Tauzin) ("[T]he total amount that we might be liable for in the event that we should lose the litigation is available for refund at 6% interest. We are likely to make more than 6% on it in investments. We are actually going to probably come out a little bit ahead on it"). This "little bit ahead" has already amounted to "almost $4.7 million." Hargroder, *1st Use Tax Will Profit La. Even If Cash Is Returned,* The Times-Picayune, Oct. 7, 1980, ¶ 1 at 17. (For the convenience of the Court, a copy of this news article is reprinted as an appendix to this brief.)[3]

## III. FERC's Responses to the First Use Tax

The Federal Energy Regulatory Commission ("the FERC"), through the adoption of an automatic tracking

[3] The frankness of the First Use Tax sponsors in admitting their motives in the 1978 committee hearings appears again in the 1980 hearings called to consider bills (not reported out of committee) designed in the face of this litigation to remove some of the more obnoxious and discriminatory exemptions to the First Use Tax. *See* Hearings on House Bills 1241, 1242, 1243, 1244, House Committee on Ways and Means (July 1, 1980) at 10 (Testimony of Attorney General Guste) ("I simply want to tell you that I believe in all sincerity, or I wouldn't be here that it would remove those arguments which could hurt the state[']s position when we pass these repeals, it will help us win the case.").

mechanism,[4] has provided a procedure for consumer reimbursement of First Use Tax payments by the natural gas pipeline companies. Although these charges are being collected subject to refund pending final judicial determination of the constitutionality of the tax, the immediate burden and incidence of the tax is being passed on directly to ultimate consumers.[5] More recently, the FERC modified its prior orders,[6] and issued a show cause order[7] on the question of whether persons other than natural gas

[4] State of Louisiana First Use Tax in Pipeline Rate Cases, Docket No. RM 78-23, Order No. 10, "Order Establishing Procedures Governing Pipeline Recovery of the State of Louisiana First Use Tax," issued August 28, 1978, 43 Fed. Reg. 45,553 (Oct. 3, 1978); Order No. 10-A, "Order on Rehearing, Modifying Prior Order, Amending Regulation and Requesting Comment," issued December 20, 1978, 43 Fed. Reg. 60,438 (Dec. 28, 1978), *appeal docketed,* Tennessee Gas Pipe Line Co. v. Fed. Energy Regulatory Comm'n, No. 78-38-13, et al. (5th Cir. Dec. 26, 1978); Order No. 10-B, "Order on Rehearing, Modifying Prior Order and Amending Regulations," issued March 2, 1979, 44 Fed. Reg. 13,460 (Mar. 12, 1979); and "Order Directing the Solicitor to Seek Either an Order of the Court Permitting the Commission to Modify Its Orders or a Remand of the Record" app. A, issued July 13, 1979, 44 Fed. Reg. 46,291 (Aug. 7, 1979).

[5] Estimates of the amount to be collected annually from the First Use Tax have varied from $225,000,000 (Plaintiffs' Complaint, para. XIV) to $275,000,000 (Brief of Pipeline Companies at p. 15). Louisiana authorities report annual collections even higher than these estimates. On July 1, 1980, Louisiana Attorney General Guste told state legislators: "That tax gentlemen is producing about 300 million dollars a year. 300 million dollars a year and it is now counted in escrow deposited at rates of interest bearing from 10 to 14%." Hearings on House Bills 1241, 1242, 1243, and 1244, House Committee on Ways and Means (July 1, 1980) at 1.

[6] State of Louisiana First Use Tax in Pipeline Rate Cases, Docket No. RM 78-23, Order No. 10-C, "Interstate Pipeline Recovery of State of Louisiana First Use Tax," issued April 24, 1980, 45 Fed. Reg. 29,011 (May 1, 1980).

[7] State of Louisiana First Use Tax in Pipeline Rate Cases, Docket No. RM 78-23 (Phase II), "Order Instituting Show Cause Proceeding," issued April 24, 1980, 45 Fed. Reg. 39,535 (June 11, 1980).

consumers should bear the burden of the First Use Tax while its constitutionality is being litigated. Aside from these possible administrative initiatives, the FERC has been stymied in its attempts to litigate the constitutionality of the First Use Tax in the lower federal courts. *FERC v. McNamara,* Civil Action No. 78-384 (M.D. La., order abstaining filed Jan. 26, 1979), *appeal noted,* No. 79-1403 (5th Cir.). Indeed, at oral argument of the FERC appeal, the Fifth Circuit indicated its intention to stay the proceedings pending further developments in this case. *See* 45 Fed. Reg. 29,011, 29,012 n.9 (May 1, 1980).

In the meantime, huge amounts of First Use Tax payments are being collected. These amounted to $364,037,997.23, which had earned $17,597,967.89 in interest (at rates between 8 and 14 percent), as of September 30, 1980. Hargroder, *1st Use Tax Will Profit La. Even If Cash Is Returned,* The Times-Picayune, Oct. 7, 1980, ¶ 1 at 17.

## IV. Recommendations of the Special Master

Although declining to recommend the grant of the motion for judgment on the pleadings, the Special Master resolved a number of issues in favor of the plaintiff states.

1. He rejected Louisiana's claim that the only reason the cost of the tax is now borne by the plaintiffs and their citizens is because of the FERC orders. Report at 12.

2. He rejected Louisiana's contention that interstate transmission of natural gas commences at the tailgate of the processing plant and concluded that the federal OCS gas involved in this case was in continuous movement in interstate commerce. Report at 32.

3. He noted that, by way of tax credits, exemptions, and exclusions for in-state users, the impact of the tax appeared directed at interstate sales, Report at 27, and

found, in particular, that "Louisiana customers of local utilities and local consumers buying directly from the pipelines are protected in whole or in part from the incidence of the tax which is passed on to consumers out of the State." Report at 34.

4. He apparently rejected out of hand virtually all but a few of the proffered taxable "uses" as even arguably constitutionally sustainable. Report at 23, 36-37.

5. He found that the "FERC had previously accepted contracts that provided that the processing involved and the tax on it were properly considered costs of producing liquid and liquefiable hydrocarbons, not properly to be borne by consumers of the natural gas." Report at 28.

6. And, perhaps most importantly, he conceded:

> As far as the Interstate Commerce Clause is concerned, the Special Master believes that a determination on the validity of the Louisiana tax could be made on the pleadings, plus a generous application of judicial notice.

Report at 21.

In addition, the Special Master acknowledged that the First Use Tax "can be considered the most recent step in Louisiana's continuing effort to press its claim to profit from the production of oil and gas off its coast." Report at 25 n.16. And he noted the "substantial advantage" Louisiana is deriving from the differential between the six percent statutory interest rate on First Use Tax refunds and the present interest rate on investments. Report at 18.

On the ultimate questions addressed by the Special Master, his remarks support the position of the plaintiff states. With respect to the plaintiff states' contention that the First Use Tax is an impermissible attempt to regulate the transportation and sale of natural gas in interstate commerce, the Special Master acknowledged: "They may be right since the impact of the tax appears to be directed at interstate sales by reason of the exemptions and credits granted intrastate users." Report at 27. Of La. Rev. Stat. Ann. § 47:1303C, he noted:

> The most substantial possible conflicts appear to be between the Louisiana tax law and the Natural Gas Act, particularly the provisions with respect to passing the burden of the tax back to the producers or forward to the consumers.

Report at 30. As to the Severance Tax Credit, the Special Master admitted:

> Since there is no apparent relation between the ownership of outer continental shelf gas and the production of gas in Louisiana, it is hard to understand Louisiana's motive in permitting this credit, but it obviously aids an intrastate operation in a way not available to a pipeline engaged only in interstate transportation or producing gas outside of Louisiana.

Report at 34.

The reasons the Special Master recommended withholding judgment on the plaintiffs' Natural Gas Act claims are twofold. First, he desired to know as a factual matter "how great an effect on the regulatory power of the FERC" is caused by the First Use Tax or in essence what "administrative adjustments" the FERC could undertake "to permit the State and federal programs to coexist." Report at 27, 21. *See also* Report at 29. Second, the Special Master noted that "[t]here is an ongoing dispute between the parties as to the legal effect of the [natural gas] processing," which he would not resolve on the basis of prior judicial opinions on the issue. Report at 21, 28-29.

On the Commerce Clause questions, the Special Master again wanted to know "what adjustments can be made [by the FERC] in the base prices, and what allowances can be made between buyers and sellers which might reduce or eliminate any disadvantage of one over the other," Report at 35, and again cited to the processing dispute. Report at 37. He also believed that facts were needed to show whether or not the First Use Tax was a "compensating" tax, Report at 35, and concluded as a matter of law that the "fair apportionment" Commerce Clause analysis does not have "any application here," unless as a factual matter "the tax is so large to put a barrier in the path of interstate commerce." Report at 36.

## ARGUMENT

### I.

### THE FIRST USE TAX MUST BE INVALIDATED AS A VIOLATION OF THE SUPREMACY CLAUSE OF THE UNITED STATES CONSTITUTION.

The plaintiff states submit that in recommending denial of the motion for judgment on the pleadings the Special Master has failed to appreciate the nature and reach of the Supremacy Clause of the United States Constitution.[8] And although he has laid every conclusory predicate for a judgment on the pleadings in the plaintiffs' favor, the Special Master has erroneously failed to follow through to the only possible legal conclusion. Moreover, he has ignored the strictly legal analysis established by this Court to resolve Supremacy Clause issues. *See, e.g., Douglas v. Seacoast Products, Inc.*, 431 U.S. 265, 271-72 (1977) (Supremacy Clause challenges are viewed as statutory for purposes of deciding statutory claims first to avoid unnecessary constitutional adjudications).

The Supremacy Clause invalidates or preempts state legislation that "stands as obstacle to the accomplishment

[8] Article VI, cl. 2, of the Constitution provides that "[t]his Constitution and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land . . . any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

and execution of the *full* purposes and objectives of Congress" in enacting the relevant federal statutes. *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941); *McCulloch v. Maryland,* 17 U. S. (4 Wheat) 316, 427 (1819) ("It is of the very essence of supremacy to remove *all* obstacles to its action . . . ."). Even harmonious state legislation will fall if the federal regulatory scheme is "so pervasive," or "touches a field in which the federal interest is so dominant," or if the object sought by the federal law reveals a purpose to dominate state law. *Ray v. Atlantic Richfield Co.,* 435 U.S. 151, 157-58 (1978).[9] Thus, in the present case, where there is a comprehensive regulatory scheme, it is not, as the Special Master suggests, that *factual* evidence of *actual* state interference with the federal scheme is necessary to invalidate the First Use Tax. The mere *possibility* of interference is enough. *See Northern Gas Co. v. State Corporation Commission of Kansas,* 372 U.S. 84, 92 (1963) ("[A]lthough collision between the state and federal regulation may not be an inevitable consequence, there lurks such imminent possibility of collision in orders purposely directed at interstate wholesale purchasers that the orders must be declared a nullity in order to assure the effectuation of the comprehensive federal regulation ordained by Congress."). *See also San Diego Building Trades Council v. Garmon,* 359 U.S. 236, 244 (1959). ("To leave the States free to regulate conduct so plainly within the central aim of federal regulation involves too great a danger of conflict between power assorted by Congress and requirements imposed by state law.").

Moreover, Supremacy Clause analysis, unlike most other areas of constitutional law, does not involve a balancing of competing interests or an inquiry into the nature or strength of the purposes served by the chal-

[9] DeCanas v. Bica, 424 U.S. 351, 358 n.6 (1976), also suggests that a state law can be found invalid "if it imposes additional burdens not contemplated by Congress."

lenged state enactment. *See Northern Natural Gas Co. v. State Corporation Commission of Kansas,* 372 U.S. at 93. If the state law conflicts with or is preempted by federal law, it may not stand. And this inquiry is purely a legal question. *Douglas v. Seacoast Products,* 431 U.S. 265, 271-72 (1977); *Philadelphia v. New Jersey,* 430 U.S. 141 (1977).

The Special Master has erroneously disregarded these sound principles to delay decision on the plaintiff states' Natural Gas Act preemption argument and to ignore their contention that the Outer Continental Shelf Lands Act invalidates the First Use Tax.

A. *The First Use Tax is preempted by and in conflict with the Natural Gas Act.*

In the Natural Gas Act, Congress "meant to create a comprehensive and effective regulatory scheme." *FPC v. Louisiana Power & Light Co.,* 406 U.S. 621, 631 (1972); *Panhandle Eastern Pipe Line Co. v. Public Service Commission of Indiana,* 332 U.S. 507, 520 (1947). The Act confers on the Federal Energy Regulatory Commission jurisdiction over the transportation and sale for resale of natural gas in interstate commerce, 15 U.S.C. § 717, including the approval of rates and charges, 15 U.S.C. §§ 717c & 717d, and the determination of costs allowable to natural gas companies. *FPC v. United Gas Pipe Line Co.,* 386 U.S. 237, 243 (1967). *See also* 15 U.S.C. §§ 3717F & 3320.[10]

A key purpose of these far-reaching provisions of the Natural Gas Act is "to protect ultimate consumers of

[10] Although the Natural Gas Act envisions a dual state-federal regulatory authority in many matters, it leaves to the states no room for direct regulation, *Public Utilities Commission of Ohio v. United Fuel Gas Co.,* 317 U.S. 456 (1943), or indirect regulation, *Northern Natural Gas Co. v. State Corporation Commission of Kansas,* 372 U.S. 84 (1963), of the transportation and sale for resale of natural gas in interstate commerce.

natural gas from excessive charges." *FPC v. Interstate Gas Co.*, 336 U.S. 577, 581 (1949). *See also Atlantic Refining Co. v. Public Service Commission of New York*, 360 U.S. 378, 388-89 (1959). This Court has said that the FPC (now the FERC) "must be free to devise methods of regulation capable of equitably reconciling diverse and conflicting interests." *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 331 (1974). Similarly, the Natural Gas Act recognizes "the importance of nationally controlling interstate pipelines in order to preserve 'equality of opportunity and treatment among the various communities and states concerned.'" *FPC v. East Ohio Gas Co.*, 338 U.S. 464, 471 (1950). *See also FPC v. Louisiana Power & Light Co.*, 406 U.S. 621, 633-35 (1972); *Louisiana v. FPC*, 476 F.2d 140, 142 (5th Cir. 1973) ("A major purpose [of the Natural Gas Act] was to prevent the 'haves' from being unfair to the 'have nots.'").

On the basis of the record in this case, the Special Master has found more than enough to establish that the First Use Tax touches this pervasive federal scheme and, even more obviously, that the operation of the tax results in the possibility of collision with the Natural Gas Act and the inhibition of its full purposes. First, he determined (and had to find) that the tax is plainly aimed at interstate sales and out-of-state consumers. Report at 27. *See Northern Natural Gas Co. v. State Corporation Commission of Kansas*, 372 U.S. at 92 ("The danger of interference with the federal regulatory scheme arises because these orders are unmistakably and unambiguously directed at purchasers who take gas in Kansas for resale after transportation in interstate commerce.") Second, he found the OCS gas to be in interstate commerce, within Commission jurisdiction, and not interrupted by in-state processing. *Id.* at 31-32. Third, he concluded (and the legislative history left him no choice but to conclude) that local interests were carefully protected from the First Use Tax.

*Id.* at 34.[11] Fourth, he recognized that the contract abrogation feature of the First Use Tax is inconsistent with contracts previously accepted by the FERC. *Id.* at 27-28. Fifth, he had to conclude, and indeed Louisiana admitted, that the tax was intended to be passed on to consumers via the regulatory mechanism. *Id.* at 28. Few state taxes are so intended, but then the First Use Tax is "not just an ordinary little tax." *See supra* at 10-11. Thus, by abrogating tax shifting contracts and declaring the tax to be a cost of marketing the gas, the Louisiana statute attempts to tie the hands of the FERC on cost determination and to force out-of-state consumers to pay the tax.

One reason the Special Master failed to reach the inevitable conclusion from this mountain of evidence of intrusion into the regulatory scheme of the Natural Gas Act was his desire to know how great an effect the First Use Tax had on that scheme and what the FERC could do to adjust competing interests. The plaintiff states submit that this inquiry is simply irrelevant. Congress obviously intended that the determination of and control over cost-pass through be for the Commission. *FPC v. United Gas Pipe Line Co.*, 386 U.S. at 243. That discretion is presently hamstrung by the First Use Tax since the only FERC choice is on which of two innocent parties to inflict the financial damage — those it regulates or consumers. But even if the FERC could take some action to balance efficient regulation with prevention of consumer overcharges, the prospect or even the possibility of a state-induced cruel or difficult regulatory choice is wholly at odds with this Court's view of the Natural Gas Act. *See Northern Natural Gas v. State Corporation Commission of Kansas*, 372 U.S. 84 (1963).

[11] The Special Master's apparent uncertainty regarding the motive for the Severance Tax Credit, *see supra* at 16, is easily dispelled when it is realized that those producing OCS gas are the same producers operating in Southern Louisiana. That is, they are local interests receiving local protection.

Another reason the Special Master declined to recommend the grant of the plaintiffs' motion for judgment on the pleadings on their Natural Gas Act claim was the "dispute between the parties as to the legal effect of the processing." Report at 28. The nature of natural gas processing has nothing to do with the plaintiffs' Supremacy Clause contentions. The Special Master has already concluded that processing does not interrupt the flow of OCS natural gas in interstate commerce or affect FERC jurisdiction over the gas. Aside from the "processing dispute," the First Use Tax interferes with FERC jurisdiction over the transportation and sale of natural gas and the allowance of costs related to these activities. *See supra* at 10-11. Moreover, the plaintiffs' view of processing as not affecting the nature of the gas for purposes of the Natural Gas Act is well established as a matter of law and judicial precedent. *Public Service Commission v. FERC,* 610 F.2d 439, 444 (6th Cir. 1979); *Deep South Oil Co. v. FPC,* 247 F.2d 882, 888 (5th Cir. 1957), *cert. denied,* 355 U.S. 930 (1958). Finally, it is important to note that the Special Master's focus on natural gas processing with respect to the Supremacy Clause claim is simply another attempt to look into the regulatory mind of the FERC to determine what may or may not be a "reasonable" cost to pass on to consumers. *See* Report at 29. This inquiry, however, is one for the FERC, not for the Special Master or this Court.

To delay the resolution of this case and invalidation of the First Use Tax with its annual costs to natural gas consumers of $300 million for such a reason is unconscionable. Rather this Court should focus on the terms of the state statute, its graphic legislative history, and its obvious legislative intent to reward the haves at the expense of the have nots. In light of the purpose of the Natural Gas Act to overcome the balkanization of natural gas regulation and the discriminatory practices of producing states, the plaintiffs submit that this tax cannot stand.

B. *The First Use Tax is preempted by and in conflict with the Outer Continental Shelf Lands Act.*

The Special Master correctly concluded that no evidentiary hearing was needed to decide the purely legal question of whether the First Use Tax was preempted by and in conflict with the Outer Continental Shelf Lands Act ("OCSLA"). 43 U.S.C. § 1332 (1976). However, he erroneously ignored the assertion of the plaintiff states that the federal ban on application of state taxation laws to the outer continental shelf, 43 U.S.C. § 1333(a)(2), prohibits the First Use Tax. Instead, he apparently assumed that the First Use Tax is not a tax on the natural gas itself or its severance but a tax on its transportation, Report at 30, and that the OCSLA tax ban applies only to taxes imposed before the natural gas has been brought into the state. *Id.* at 29. Under the First Use Tax, he said, "no tax is imposed on any action or person until the gas has been brought into the state." *Id.*

The plaintiff states submit that in failing to act favorably on their OCSLA contentions the Special Master has misunderstood the motivation and operation of the First Use Tax and has failed to give appropriate scope to the state tax ban contained in 43 U.S.C. § 1333 (a)(2).

Without a doubt, Louisiana could not directly tax the natural gas produced on the outer continental shelf. The Outer Continental Shelf Lands Act expressly prohibits it. 43 U.S.C. § 1333(a)(2) (1976), *as amended by* Act of Sept. 18, 1976, Pub. L. No. 75-372, 92 Stat. 635 (codified at 43 U.S.C.A. 1333(2)(A) (West Supp. 1980)) ("State taxation laws shall not apply to the outer Continental Shelf.") *Mobil Oil Corp. v. FPC,* 417 U.S. 283, 293 n.7 (1974). This state tax prohibition, reenacted in 1978 in the Outer Continental Shelf Lands Act Amendments of 1978, Pub. L. No. 95-372, 92 Stat. 629, demonstrates congressional recognition that such taxation will impede the purpose of the Act in providing for the orderly development of shelf resources. Even in the absence of such a prohibition, this taxation would be prohibited. *See Mississippi River Fuel Corp. v. Cochreham,* 382 F.2d 929 (5th Cir. 1967), *cert. denied,* 390 U.S. 1014 (1968) (holding that the Louisiana Severance Tax could not constitutionally be imposed on the severance of oil and gas by a lessee under a mineral lease from the United States on federal land in Louisiana).

With the First Use Tax, however, Louisiana tries to accomplish indirectly what it cannot do directly. An avowed purpose of the Louisiana First Use Tax is to compensate the state for the alleged environmental damage caused by the severance of natural gas beyond the boundaries of Louisiana. La. Rev. Stat. Ann. § 47:1301B (West Supp. 1980). Indeed, the defendant has admitted that the purpose of the First Use Tax is to compensate Louisiana for a lack of OCS royalties distributed under the OCSLA and that the tax is aimed at federal OCS gas. *See* Proffer of Proof at ¶¶ 49, 51, 69. And the Special Master himself found that the First Use Tax was "the most recent step in Louisiana's continuing efforts to press its claim to profit from the production of oil and gas off of its coast." Report at 25 n.16.

In concept and operation, the tax is virtually indistinguishable from a severance tax on federal OCS gas. It is justified as an attempt to remedy the alleged discriminatory effect of the state's own severance taxes on Louisiana natural gas producers. La. Rev. Stat. Ann. § 47:1301A. The tax is imposed only if no state severance tax is due or has been paid on the gas and is set at the same rate as the severance tax. La. Rev. Stat. Ann. § 47:647. Although the First Use Tax proclaims that it should not be construed as imposing a tax on the production, severance, or ownership of natural gas produced outside the boundaries of Louisiana, La. Rev. Stat. Ann. § 47:1303E, the clear thrust of the statute is to impose a severance tax on natural gas produced outside Louisiana. The statute by exemption, credit, and pass-through ensures that the burden of the tax will fall on federal OCS gas and ultimately on the out-of-state consumer.

The Special Master's refusal to recognize that even an "indirect" state severance tax on federal OCS gas, like the First Use Tax, is prohibited by 43 U.S.C. § 1333(a)(2), is compounded by his reading and reliance upon *Portland Pipeland Corp. v. Environmental Improvement Commission, 307 A.2d 1 (Me. 1973), appeal dismissed,* 414 U.S. 1035 (1973). That case rejected a constitutional challenge to a state tax challenged as a tax on oil, but defended as a tax on the transportation of the oil. However, it is important to note that the *Portland Pipeline* case was an Import-Export Clause case not a Supremacy Clause one and that the primary reason the Maine court concluded that the tax was not upon the oil was because over the long run the tax was not related to the volume of oil transported. 307 A.2d at 33-34. The First Use Tax is imposed on the entire volume of federal OCS natural gas passing through the state and thus even under the rationale of *Portland Pipeline* should be considered a tax on federal OCS gas.

The Louisiana First Use Tax contradicts the express language of the OCSLA as well as its statutory purpose of providing for the orderly development of offshore resources and natural gas development on the outer continental shelf. For these reasons, the tax violates the Supremacy Clause and is void in its entirety. Even Louisiana's purported rationales for the First Use Tax raise questions under the Supremacy Clause. The First Use Tax states its concern with the physical and economic waste of Louisiana's gas. La. Rev. Stat. Ann. § 47:1301A (West Supp. 1980). This concern does not support a tax on federal OCS gas moving in interstate commerce, however, because the economic waste of such gas is a matter of exclusive federal jurisdiction. *FPC v. Transcontinental Gas Pipeline Corporation,* 365 U.S. 1 (1961). To the extent that the Louisiana statute purports to be concerned with the physical waste associated with natural gas severance from the federal domain in the outer continental shelf, Congress has deemed this a federal concern, *see* 43 U.S.C. § 1334(a)(1) (1976), *as amended by* Act of Sept. 18, 1978, Pub. L. No. 95-372, 92 Stat. 636 (codified at 43 U.S.C.A. § 1334(a)(1) (West Supp. 1980)) (authorizing the federal government "to provide for the prevention of waste and conservation of the natural resources of the outer Continental Shelf, and the protection of correlative rights therein, . . ."), and has enacted specific schemes for the management of and compensation for such waste. *See* Coastal Zone Management Act of 1972, 16 U.S.C. §§ 1451-1464 (1976), *as amended* by Act of July 26, 1976, Pub. L. No. 94-370, 90 Stat. 1013 (codified at 16 U.S.C.A. §§ 1451-1464 (West Supp. 1980)), and Outer Continental Shelf Lands Act Amendments of 1978, Pub. L. No. 95-372, 92 Stat. 629 (codified at 43 U.S.C.A. §§ 1331-1356 (West Supp. 1980)).

## II.

### THE FIRST USE TAX ON ITS FACE VIOLATES THE COMMERCE CLAUSE OF THE UNITED STATES CONSTITUTION

The Commerce Clause, U.S. Const. art. I, § 8, cl. 3, provides that Congress has the power:

> To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes . . . .

This grant of power to Congress constitutes a withdrawal of power from the states. *Boston Stock Exchange v. State Tax Commission,* 429 U.S. 318, 328 (1977). Specifically, the Commerce Clause mandates that a state tax on interstate commerce must be: (1) "fairly apportioned"; (2)

"not discriminat[ory] against interstate commerce"; (3) "applied to activity with a substantial nexus with the State"; and (4) "fairly related to the services provided by the State." *Department of Revenue of Washington v. Association of Washington Stevedoring Companies,* 435 U.S. 734, 750 (1978). If a state tax fails *any one* of these four tests, it must be held unconstitutional as a violation of the Commerce Clause.

The First Use Tax on its face violates two of these criteria: it unfairly discriminates against interstate commerce, and it is not fairly apportioned thus creating the risk of multiple taxation. Accordingly, this Court should grant the plaintiff states judgment on the pleadings on these grounds. *See Boston Stock Exchange v. State Tax Commission,* 429 U.S. 318 (1977) (discrimination against interstate commerce); *Michigan-Wisconsin Pipeline Co. v. Calvert,* 347 U.S. 157 (1954), *approved in Department of Revenue of Washington v. Association of Washington Stevedoring Companies,* 435 U.S. 737, 749 n.18 (fair apportionment).

The Special Master specifically recognized that judgment could be enterd on the pleadings regarding the burden of the tax on interstate commerce:

> As far as the Interstate Commerce Clause is concerned the Special Master believes that a determination on the validity of the Louisiana Tax could be made on the pleadings, plus a generous application of judicial notice.

Report at 21. Indeed, it appears that the only reason he failed to grant judgment on the pleadings to the plaintiff states was because of his reluctance to interfere with a "State's prerogative to manage its own fiscal affairs." *Id.* Invalidating a state tax may be, as the Special Master concluded, a "serious limitation" on this "prerogative"; however, this Court has clearly found this "limitation" does not require evidentiary hearings be held if the state tax, on its face, violates the Commerce Clause. As this Court explained when finding a New York transfer tax unconstitutional on its face:

> Our decision today does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry. . . . We hold only that . . . no State may discriminatorily tax the products manufactured or the business operations performed in any other State.

*Boston Stock Exchange v. State Tax Commission* 429 U.S. at 336-37.

Moreover, although he found further evidentiary proceedings appropriate, the Special Master properly rejected most of the material which Louisiana proferred as indicating a dispute as to material facts with regard to the Commerce Clause claims. Perhaps the most vivid illustration of this is Louisiana's repeated insistence that the natural gas subject to the First Use Tax is not in interstate commerce and thus its taxation could not possibly violate the Commerce Clause. The Special Master summarily rejected this "proferred fact" and correctly found, as a matter of law, that the gas subject to the First Use Tax is indeed in interstate commerce. Report at 31-32. The plaintiff states submit that simple examination of the First Use Tax will similarly lead this Court to conclude that, as a matter of law, it discriminates against interstate commerce and is not fairly apportioned.

A. *The First Use Tax unfairly discriminates against interstate commerce.*

The First Use Tax unfairly discriminates against interstate commerce in three separate respects. First, the tax is discriminatorily imposed only on gas imported into Louisiana (whether from a sister state or from outside the

United States) and on gas produced from the OCS.[12] An equivalent tax is not imposed on gas produced in Louisiana or on gas transported into Louisiana from any state that imposes a severance tax. Yet the post production flow of such gas enjoys the same protections and privileges, and subjects Louisiana's environment to the same purported damages, as OCS and imported gas. Second, the First Use Tax, applied in conjunction with the Severance Tax Credit (La. Rev. Stat. Ann. § 47:647), discriminates against — and is intended to discriminate against[13] — interstate commerce because it eliminates the entire burden of the First Use Tax from those pipeline companies who produce natural resources subject to the Louisiana Severance Tax, thus discriminating against pipeline companies who do not. Third, the First Use Tax applied in

[12] As noted above, although Louisiana has continually argued to the contrary, the Special Master correctly found that as a matter of law this gas is in interstate commerce because (a) "natural gas is in interstate commerce during the entire journey" (Report at 32), *i.e.*, from the time the gas is produced for the outer continental shelf through the processing plant to its ultimate destinations, *see* California v. Lo-Vaca Gathering Co., 379 U.S. 366, 369 (1965); and (b) "the movement from the outer continental shelf across the state boundary and up to the processing plant would itself seem to be an interstate journey. *See Continental Oil Co. v. Federal Power Commission,* 370 F.2d 57, 66 (5th Cir. 1966)." Report at 32.

[13] The legislative history is particularly informative in this regard. It is replete with assertions that the legislation will not harm Louisiana, but only out-of-staters. For example, the sponsor of the legislation told his colleagues: "I want to say for the entire package presented to you today, it has been amended as far as we can practically go to *guarantee against any impact upon producers and processors and people in this state* who would otherwise possibly feel some impact from the imposition of the tax." Hearings of H.B. 768, Senate Committee on Revenue and Fiscal Matters (June 26, 1978) at 3 (Testimony of Mr. Tauzin) (emphasis added). Or as another supporter of the tax assured the Louisiana legislators: "I think it's a general consensus and I know it is mine. If the first use tax is passed it's going to be a passed on tax, no question about it." Hearings of H.B. 768, House Committee on Ways and Means (June 5, 1978) at 12 (Testimony of Mr. LaBorde).

conjunction with the Tax Credit for In-State Electric and Natural Gas Utility Service (La. Rev. Stat. Ann. § 47:11) and various exemptions for certain favored in-state uses — *e.g.*, production of sulphur, fertilizer and anhydrous ammonia — that would otherwise be subject to the tax (La. Rev. Stat. Ann. § 47:1303(A)), discriminates against interstate commerce by disadvantaging identically situated out-of-state users.

Thus, the First Use Tax, together with its companion credits and exemptions, is on its very face manifestly "tailored" to fall on interstate commerce and discriminate against out-of-state residents. Moreover, as previously noted, *supra* at 11, the Louisiana legislature actually planned and intended that this tax would fall exclusively on non-residents.[14] However, this Court has expressly found that:

> Any tailored tax of this sort creates an increased danger of error in apportionment, of discrimination against interstate commerce, and of a lack of relationship to the services provided by the State. *See Freeman v. Hewit,* 329 U.S. at 265-266, n.13 (concurring opinion). *A tailored tax, however accomplished, must receive the careful scrutiny of the courts to determine whether it produces a forbidden effect on interstate commerce.*

*Complete Auto Transit Inc. v. Brady,* 430 U.S. 274, 288-89 n.15 (1977) (emphasis added). The plaintiff states submit that such scrutiny here mandates the conclusion that the First Use Tax be held on its face to discriminate against interstate commerce.

[14] See also the detailed comments, which were apparently illustrated by charts, of the First Use Tax's principal sponsor, demonstrating that every conceivable Louisiana group which would otherwise be subject to the First Use Tax was protected by exemption or credit from it. Hearings of H.B. 768, Senate Committee on Revenue and Fiscal Affairs (June 26, 1978) at 3-4 (Testimony of Mr. Tauzin).

The Special Master specifically recognized that the Louisiana tax discriminates in favor of domestic interests at the expense of burdening interstate commerce. The only industries excluded from the tax are "all within the State." Report at 33. The credit against the First Use Tax for severance taxes paid by domestic producers was seen to result in a greater tax burden on foreign firms and consumers. For example, the Special Master acknowledged:

> [The Severance Tax Credit] obviously aids an intrastate operation in a way not available to a pipeline engaged only in interstate transportation or producing gas outside of Louisiana.

*Id.* at 34. The Special Master also expressly adopted the Federal Government's description of the taxing scheme and the benefits accorded in-state businesses:

> This difference can be illustrated by the following example. Owner A has 1000 mcf of OCS gas; owner B has 500 mcf of OCS gas and 500 mcf of gas subject to Louisiana's severance tax. A owes $70 of first use tax; B owes $35 of first use tax and $35 in severance tax. B, however, pays only $35 in first use taxes. He owes no severance tax because he can credit the first use payment against the severance tax liability.

*Id.* at 34 n.18 (quoting from Brief of the United States and the FERC at 51 n.47). In short, the Special Master rejected Louisiana's claim that the tax "does not discriminate," concluding:

> Louisiana customers of local utilities and local consumers buying directly from the pipelines are protected in whole or in part from the incidence of the tax which is passed on to consumers out of the State.

*Id.* at 34. The Report of the Special Master is thus replete with observations of the facially discriminatory nature of the First Use Tax.

Despite these observations, the Special Master declined to recommend this Court find that the First Use Tax on its face discriminates against interstate commerce. The plaintiff states submit that this failure so to recommend results from two fundamental errors in the Special Master's analysis.

First, the Special Master erred in finding that an evidentiary hearing is appropriate to determine "what adjustments can be made in the base prices, and what allowances can be made between buyers and sellers which might reduce or eliminate any disadvantage of one over the other." Report at 35. This view has no legal basis. For this Court has never required an interstate business to adjust its prices or make allowances to its customers to rectify a competitive imbalance created by a state tax. Rather, the inquiry has been whether the taxing scheme under consideration will operate, of itself, to discriminate against interstate commerce.

This Court has recognized that a tax, which when considered in the overall taxing scheme appears on its face to be non-discriminatory, may still be held unconstitutional if the tax through its practical operation effectively discriminates against interstate commerce. *See, e.g., Halliburton Oil Well Cementing Co. v. Reily,* 373 U.S. 64 (1963). More important for the present case, however, is this Court's recognition that an examination of practical operation is not necessary or warranted if the statute is unconstitutionally discriminatory on its face. *See, e.g., Boston Stock Exchange v. State Tax Commission,* 429 U.S. 318 (1977). Since a determination of facial invalidity can be made by considering the statute in question and its companion statutes, there is obviously no need for factual development, and thus the present case can and should be resolved on the pleadings.

The second error in the Special Master's analysis is his determination that a hearing is appropriate because "the 'actuality of operation' may show that the tax is a 'compensating' tax intended to complement the State severance tax as the use tax complemented the sales tax in *Henneford v. Silas Mason Co.,* 300 U.S. 577 (1937)." Report at 35. This conclusion is incorrect — no evidentiary hearing is necessary on this matter because the determination of whether or not the First Use Tax is a "compensating" tax with respect to the state Severance Tax is a decision that can and should be made as a matter of law from a consideration of the respective statutes and their purposes.

For example, in the case upon which the Special Master relies, *Henneford v. Silas Mason Co.,* 300 U.S. 577, 581 (1937), a use tax was found constitutional because it accomplished the traditional role of a use tax, *i.e.,* to complement a sales tax by ensuring that the same activities, purchases at retail, were subject to the same tax burden, regardless of where the purchase was made, thereby placing the same in-state and out-of-state activities on an equal competitive footing.

The First Use Tax is clearly not such a compensating tax with respect to the Louisiana Severance Tax. The First Use Tax is imposed on federal OCS gas when it is first subjected to one of the activities defined as "uses" in the statute, while the Severance Tax is imposed on Louisiana gas as a result of a totally different activity — the severing of such gas from the soil or water bottoms of the state. Furthermore, the purposes underlying the two taxes are very different. The Severance Tax is "an excise tax upon the privilege of severing resources" from within Louisiana's borders, and is based upon the state's "inherent power . . . to regulate the severance of its natural resources." *State v. Standard Oil Co. of Louisiana,* 178 So.

601, 626 (La. 1938). The stated purposes of the First Use Tax, on the other hand, are:

> to require the exaction of fair and reasonable compensation to the citizens of this state for the costs incurred and paid with public funds, which costs enure solely to the benefit of the owners of natural gas produced beyond the boundaries of Louisiana, although introduced into the state, and to provide some measure of reimbursement to the citizens for damages to the state's water bottoms, barrier reefs, and sensitive shorelands as a direct comsequence of activity within the state associated with such natural gas by the owners thereof.

La. Rev. Stat. Ann. § 47:1301(C). The Severance Tax does not seek to compensate the state for the extra costs incurred and paid with public funds for benefits which enure only to the owners of the gas or oil. Nor does the Severance Tax seek to compensate the state for damages to the state's water bottoms, barrier reefs, and sensitive shorelands as a direct consequence of activity within the state. Likewise, the First Use Tax is not designed to compensate the state for the depletion of its natural resources.

Finally, the First Use Tax does not have the salutary effect typical of "compensatory" taxes, *i.e.*, preventing residents of the taxing state from escaping sales tax liability by purchasing goods from out-of-state retailers. In the usual case, a compensating use tax prevents residents who make out-of-state purchases from getting a "free ride" at the expense of residents who purchase their goods in-state. Both purchasers receive governmental services, but without the compensating tax only the in-state purchasers would pay for those services with their taxes. No such compensating result is achieved by the First Use Tax since it is designed to be passed on to residents of other states. Rather, the First Use Tax reverses the result: *out-of-state consumers who receive no* *governmental services from Louisiana bear the brunt of the tax; people who receive Louisiana's governmental services pay no tax whatever.*

The plaintiff states are not aware of any case that has considered whether a use tax can complement and compensate for any tax other than a sales tax. However, this Court has recognized that, even in a true use tax-sales tax situation, the use tax must be applied so as to equalize the competitive positions of taxpayers similarly situated. *Halliburton Oil Well Cementing Co. v. Reily,* 373 U.S. 64, 70 (1963). There, the Court articulated the test for the validity of a valid use or compensating tax:

> Equal treatment for in-state and out-of-state taxpayers similarly situated is the condition precedent for a valid use tax on goods imported from out-of-state.

The *Halliburton* court found it impermissible to justify the imposition of a use tax by comparing the activities of a manufacturer-user to those of a purchaser at retail. Similarly, Louisiana cannot legally justify the imposition of the First Use Tax by comparing the interstate transportation of federal OCS gas by the pipeline companies to the severance of oil and natural gas from the state's domain by oil and gas producers.

It should be noted that the Special Master permitted Louisiana to file an offer of proof indicating the purported necessity for an evidentiary hearing. The plaintiff states responded to Louisiana's proffer by demonstrating that the "evidence" to be offered consisted of purely legal arguments, irrelevant or immaterial points, and a handful of items capable of judicial notice. The Special Master cited not one iota of alleged evidence from Louisiana's proffer to justify recommending denial of judgment on the pleadings. Louisiana is not even prepared, therefore, to justify its unconstitutional tax on the points discussed by the Special Master.

Thus, for all of these reasons, the Special Master erred in concluding that evidence was needed to determine whether "actuality of operation" shows that the First Use Tax operates as a complement to the Severance Tax. As demonstrated above, the First Use Tax cannot, as a matter of law, be deemed to be a compensating tax that complements Louisiana's Severance Tax.

*B. The First Use Tax is not fairly apportioned.*

The First Use tax is not fairly apportioned because it is not related to the taxpayer's investment in facilities, actual business activities, gross receipts, payroll, or any other identifiable activity within the State of Louisiana. The tax is a tax on federal OCS gas, not on local activities. This Court in recent years has approved a tax as apportioned properly only when the tax was levied solely on the *value* of an *identifiable activity* that occurred *within* the state. *Department of Revenue of Washington v. Association of Washington Stevedoring Companies,* 435 U.S. 734 (1978); *Complete Auto Transit, Inc v. Brady,* 430 U.S. 274 (1977). Here the First Use Tax is not in any way apportioned to any activities occurring in Louisiana. Rather the tax is measured by the *total volume* of the natural gas shipped in interstate commerce through Louisiana.

The Special Master, however, found that this "fair apportionment requirement" has no application here because:

> Just as a sales tax, or a severance tax, is imposed on the total amount of the commodity sold or produced, so it would seem appropriate to levy a use tax on the total amount involved.

Report at 36. This conclusion ignores the "beggared" nature of the definition of "use" in the First Use Tax. *Cf. Michigan-Wisconsin Pipeline Co. v. Calvert,* 347 U.S. 157, 161 (1954). Unlike severance and use taxes, where the taxable event typically can occur *only once* so that taxing the total amount of the commodity does not create a risk of multiple taxation, there is no such limitation upon the occurrence of "uses" as defined in First Use Tax. Rather, other than those limited "uses" that involve actual consumption or utilization of the gas within Louisiana (which, as already shown, are exempt from First Use Tax by virtue of the exemptions, exclusions, and credits provided), any one or more of several of the other "uses" as defined in First Use Tax clearly can and probably does occur in one or more of the several states through which the gas travels in its interstate journey beyond Louisiana to ultimate consumers. For example, the pipeline companies typically sell gas to distribution companies to which they transfer possession or relinquish control at the point of delivery — both the "sale" and "transfer of possession or relinquishment of control at a delivery point in the state" are "uses" under the First Use Tax that typically do occur again in other states.

The Special Master may have recognized some of the difficulty, suggested above, in holding "fair apportionment" is inapplicable in the case at hand, for in the very next paragraph of his Report he discusses at length the leading fair apportionment case, expressly recognizing that it is "[p]robably the case which on its facts is closest to this one . . . ." Report at 36. That case, *Michigan-Wisconsin Pipeline Co. v. Calvert,* 347 U.S. 159 (1954), is indeed markedly similar to the present case. Thus, it is noteworthy that there this Court held the tax unconstitutional precisely because it would "permit a multiple burden" on interstate commerce. *Id.* at 170. Texas had levied a tax on the entire volume of natural gas "gathered" within the state, and "gathering" was, the Court noted, "artificially defined" as the first taking or first retaining of possession of such gas. *Id.* at 164. Accordingly, the Court held that "if Texas may impose this 'first taking' tax measured by the total volume of gas so taken, then Michigan and the other recipient states have at least equal rights to tax the first taking or 'unloading' from the pipeline of the same gas when it arrives for distribution." *Id.* at 170. Furthermore, "Oklahoma might then seek to tax the first taking of the gas as it crossed into that state" and the "net effect would be substantially to resurrect the customs barriers which the Commerce Clause was designed to eliminate." *Id.* No facts were presented by the taxpayer to support this multiple burden argument. Rather, the Court was satisfied that the activity taxed was *so closely related to interstate commerce that the risk of multiple taxation was not constitutionally permissible.*[15]

Here, as demonstrated above, the activities taxed, *i.e.*, the "uses," are similarly so closely related to interstate commerce that the risk of multiple taxation is simply not constitutionally permissible. The Special Master suggests that because, in his view, there is a "dispute among the parties as to the legal effect of the "processing' use," judgment on the pleadings is not possible. Report at 37. This finding is simply wrong. First, the Special Master's conclusion that there is a legitimate dispute between the parties as to this issue seems to be squarely at odds with his earlier correct holding that "gas which is produced from the outer continental shelf, brought ashore by the pipelines, *processed* in plants which remove pollutants . . . , delivered to interstate pipelines and transported out of the State" is "during the entire journey" in interstate commerce. *Id.* at 31, 32 (emphasis added). Moreover, even if there is a legitimate dispute as to whether the "processing use" is or is not in interstate commerce, it is,

[15] It is crystal clear that this analysis in *Michigan-Wisconsin* is still controlling and thus applicable here, for this Court specifically approved it recently. Department of Revenue of Washington v. Association of Washington Stevedoring Companies, 435 U.S. 739, 749 n.18 (1978).

as the Special Master himself conceded, a "legal" dispute, and this in no way prevents this Court from determining, as a matter of law, that the definition of "uses" here, like that of "gathering" in *Michigan-Wisconsin,* is a "beggared" definition and so the risk of multiple taxation is impermissible. Indeed, even if the gas is not subject to processing in other states, the First Use Tax is unconstitutional since, as is demonstrated above, the same type of activity having the same relation to the gas, clearly could occur in all the other states through which the gas is transported.

For all of these reasons, the Special Master erred in concluding that an evidentiary hearing is necessary to determine whether the First Use Tax is fairly apportioned.

## CONCLUSION

The Louisiana First Use Tax poses a real threat to the free course of interstate commerce. This contest does not concern a tax levied on gas from property of the State of Louisiana; the tax is assessed only on gas derived from federal enclaves within Louisiana or from the federal domain on the outer continental shelf. Louisiana seeks to surcharge the transportation of a commodity originating outside Louisiana and merely passing through its boundaries. At all times the purpose of the tax is to favor Louisiana interests at the expense of other states, regions, and peoples of this nation. The "evil of protectionism" in this case is patent. *See Philadelphia v. New Jersey,* 437 U.S. 617, 626 (1978). Indeed, the Special Master himself repeatedly recognized the discrimination.

The Louisiana First Use Tax raises the spectre of balkanization. If one state can tax a commodity in interstate commerce without apportionment and to the benefit of its in-state interests, then each state may similarly burden that commerce. This Court should strike down Louisiana's dangerous impediment to the free flow of trade.

Moreover, the First Use Tax is a carefully contrived effort by a single state to tax the interstate transportation and sale of natural gas, an area within the exclusive jurisdiction of the federal government. It is an attempt to exploit out-of-state consumers with excessively high prices, usurp the power of the FERC with regulation masked as taxation, and hinder the development of gas from the outer continental shelf by imposing a tax that federal law expressly prohibits. Accordingly, the First Use Tax patently violates the Supremacy Clause of the Constitution and must be enjoined.

For each and all of these reasons, and for those appearing in their brief in support of the motion for judgment on the pleadings, the plaintiff states urge that their exceptions be sustained and that the Court enter a decree granting judgment as prayed for in the complaint, i.e., declaring and adjudging, pursuant to 28 U.S.C. § 2201 (1976), that the Louisiana First Use Tax is unconstitutional and unenforceable with respect to natural gas transported or sold in interstate or foreign commerce; issuing a permanent injunction prohibiting the defendant and its agents and employees from collecting the First Use Tax with respect to natural gas transported or sold in interstate or foreign commerce; ordering that any and all revenues collected pursuant to the First Use Tax with respect to natural gas transported or sold in interstate commerce be refunded to the taxpayers together with interest earned thereon; and granting the plaintiff states their costs herein expended and such other and further relief as the Court may deem just and proper.

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# APPENDIX

The Times-Picayune/The States-Item

Tuesday, October 7, 1980 Section 1, Page 17

# 1st-Use Tax Will Profit La. Even If Cash Is Returned

by CHARLES M. HARGRODER
Capital Bureau

BATON ROUGE — Louisiana stands to profit from its "first-use" tax on off-shore gas passing through the state whether or not the U.S. Supreme Court upholds the constitutionality of the tax, two state officials said Monday.

Receipts from the first-use tax are being held in escrow pending a Supreme Court decision on a suit by eight states contesting its legality. Should the court rule against Louisiana, the state would have to return the money and pay an additional 6 percent interest to those who paid the tax.

However, state Treasurer Mary Evelyn Parker said more than $364 million in receipts from the tax has been invested since April 1, 1979, when the tax became effective, at interest rates higher than 6 percent. The state thus will profit from the tax even if the court orders that the money be reimbursed with interest, Parker said.

She said that first proceeds of the tax were invested in August, 1979. Through September this year, total receipts of taxes — $364,037,997.23 — had earned $17,597,967.89.

At 6 percent for about one year's investment, earnings would figure roughly $12.9 million. So, if the state had to return principal and interest of 6 percent, it would still retain almost $4.7 million — earnings above the 6 percent rate.

Attorney General William J. Guste Jr. said interest on the money so far has averaged between 8 and 14 percent.

The state is gambling that it will get to keep it all, and continue to reap tax income from offshore wells.

The state imposes a tax of 7 percent on each 1,000 cubic feet of natural gas pumped onshore from federal leases.

Guste said that, even if the state loses its case before the high court, the decision may provide the state with guidelines on writing a law that could pass the test of constitutionality.

Monday, the high court agreed in Washington to study expanding the lawsuit.

The justices said they will hear arguments over requests by New Jersey, the federal government and 17 natural gas pipeline companies to intervene in the case.

The court also will consider whether the case should be decided on written briefs already submitted,

*(continued)*

or allow a special master to gather more evidence.

Last June 18, eight states — Illinois, Indiana, Maryland, Massachusetts, Michigan, New York, Rhode Island and Wisconsin — won permission to sue Louisiana in the Supreme Court without first airing their complaint in a lower court.

The Constitution empowers the court to invoke its "original jurisdiction" in resolving certain disputes between states without waiting for lower court rulings.

Such cases often take years to resolve, and last March 3, the court appointed Washington, D.C., lawyer John Davis as a special master in charge of gathering facts and making recommendations to the justices.

He has not yet made any recommendations on the merits of the suit. But after studying the intervention requests, Davis recommended that the list of plaintiffs suing Louisiana be expanded.

In addition, he recommended that the Associated Gas Distributors be allowed to enter the case as a friend-of-the-court in support of striking down the Louisiana tax. That recommendation also was scheduled for argument.

The treasurer invests the first-use money in short-term U.S. Treasury obligations and in certificates of deposit with Louisiana banks.

The 1978 Legislature created the first-use tax as a means of compensating the state for government expenses incident to offshore production beyond state limits.

Louisiana already collects a severance tax on production on state-owned water bottoms off the coast, just as it does from inland production.

The Legislature maintains that the state faces financial obligations resulting from production on federal lands from which the state receives no compensation — such things as additional education costs for children of offshore workers, additional usage of roads and bridges, law enforcement and a number of public programs.

Guste said the Supreme Court will be asked to decide on two contested recommendations by the master they named to hear the case:

—Whether the Supreme Court or state courts have original jurisdiction. Louisiana says it is a matter for state courts in that it is a question of its own citizens — the pipelines — contesting a state tax. Eight other states say that suits of one state against another lie within the Supreme Court's jurisdiction, and as ultimate consumers they are plaintiffs against Louisiana.

—Whether the law is unconstitutional as an impediment to interstate commerce, and because federal law assigns pricing of natural gas to the Federal Energy Commission.

The longer litigation lasts, however, the more taxes Louisiana collects, escrows, invests, and benefits.