In the

Supreme Court of the United States

FEDERAL POWER COMMISSION, Petitioner, - and - DUDLEY T. DOUGHERTY, et al., Co-EXECUTORS, ESTATE OF MRS. JAMES R. DOUGHERTY, et al, Petitioners, v. TEXACO INC., et al., Respondents.	)	No. 72-1490 No. 72-1491

Washington, D. C.,

February 19, 1974

Pages 1 thru 49

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FEDERAL POWER COMMISSION, :

Petitioner, :

v. : No. 72-1490

TEXACO INC., et al., :

Respondents. :

- - and - - - - - - - - - - - - - - :

DUDLEY T. DOUGHERTY, et al., :
CO-EXECUTORS, ESTATE OF MRS. :
JAMES R. DOUGHERTY, et al., :

Petitioners, :

v. : No. 72-1491

TEXACO INC., et al., :

Respondents. :

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Washington, D. C.,

Tuesday, February 19, 1974.

The above-entitled matters came on for consolidated argument at 10:55 o'clock, a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

MARK L. EVANS, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D. C. 20530; for the Federal Power Commission.

BEN F. VAUGHAN, III, ESQ., Graves, Dougherty, Hearon, Moody & Garwood, 204 Austin National Bank Building, Austin, Texas 78701; for Dudley T. Dougherty, et al.

CHRISTOPHER T. BOLAND, ESQ., Gallagher, Connor and Boland, 821 Fifteenth Street, N. W., Washington, D. C. 20005; for Interstate Natural Gas Association of America, Respondent.

PETER H. SCHIFF, ESQ., General Counsel, Public Service Commission of the State of New York, 44 Holland Avenue, Albany, New York 12208; for the Public Service Commission of the State of New York, Respondent.

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C O N T E N T S

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments next in Federal Power Commission against Texaco, No. 72-1490; and No. 72-1491, Dougherty against Texaco.

Mr. Evans.

ORAL ARGUMENT OF MARK L. EVANS, ESQ.,

ON BEHALF OF FEDERAL POWER COMMISSION

MR. EVANS: Mr. Chief Justice, and may it please the Court:

These cases are here on writ of certiorari to the Court of Appeals for the District of Columbia Circuit. They concern the validity of certain orders of the Federal Power Commission adopting a new method of regulating the sales of natural gas producers -- sales by a class of small natural gas producers in interstate commerce.

Following my argument on behalf of the Commission, Mr. Vaughan will argue on behalf of the other petitioners for approximately five minutes. They are among the class of small producers that are effective by the Commission's orders in this case.

It is now almost universally recognized that we are experiencing an increasingly critical shortage of natural gas. The orders at issue in this case are part of the Federal Power Commission's vigorous program for combatting that shortage, by encouraging new exploration and development of the natural gas reserves in this country.

The orders rest on the Commission's authority under Section 16 of the Natural Gas Act, which gives it the authority to classify persons within its jurisdiction and to prescribe different requirements for different classes.

The class involved here is not a new one. The Commission has previously given specialized rate treatment to this group of small producers, and this Court held, in the Permian Basin case, that:

"The problems and public functions of the small producers differ sufficiently to permit their separate classification."

Those problems and public functions were described in some detail in the Permian opinion, and the facts are the same today.

Small producers account for only about 10 to 15 percent of the gas that is transported in interstate pipelines. And their prices generally follow the prices that large producers are able to get for their gas.

But while they contribute only a small portion of the interstate gas, they have traditionally been responsible for about 80 percent of the exploratory drilling; much of it in areas that have not previously been explored -- which makes it a highly risky operation.

The result is, as this Court stated in Permian, and I quote again: Their contribution to the search for new gas reserves is significant, but it is made at correspondingly greater financial risk and at higher unit cost.

The principal impediment to the small producers' exploratory efforts has been a lack of adequate financing. The comment submitted to the Commission in this proceeding, for example, at page 84 of the Appendix suggests that small producers must rely principally on revenues from current sales in order to finance their exploratory activities.

That is so because the hazards of their exploration are such that it makes it difficult to depend upon debt financing, and because the small producers, unlike the large producers, seldom have other operations to generate the funds that they can use for exploration.

Given this situation, the Commission devised, in this rulemaking proceeding, a new regulatory program designed to take advantage of the small producers' unique situation.

I want to emphasize that this Court has before it only the orders that would set up the program, it is not reviewing any order applying this new program to the facts of any particular case. The Court's review, consequently, is a limited one.

The only question is whether the Act prohibits the Commission from experimenting along the lines that it has chosen to follow.

And this Court has stated on a number of occasions that one who challenges the validity of orders of the Federal Power Commission bears a heavy burden of showing that it will lead to unjust and unreasonable results.

The Power Commission's plans has these features:

First, instead of following the ordinary procedure of having each new sale of natural gas certificated in the public -- as in the public convenience and necessity, small producers are granted a blanket certificate, which covers all sales up to a stated maximum annual volume.

This particular feature is not a new one, either. A similar blanket certificate procedure was established as part of the Permian proceeding and was approved by the Court in principle in that case.

Second, the small producer acting under this blanket certificate may sell gas at whatever contract price he is able to negotiate. Even if it is higher than the areawide maximum rates that have been established by the Commission as just and reasonable for other purposes.

Now, this aspect of the order is new. The prior blanket certificate procedure permitted sales at rates up the area maximum but not higher.

The purpose in this order to give some play to market forces, to see whether prices would in fact exceed the area maximum and, if so, whether they would make it more attractive and more feasible for the small producers to engage in the kind of exploratory drilling that's been his history.

A third feature of the order is that in order to permit the small producer to rely on his current revenues in planning his exploratory program, the rates that are collected under the contract are not subject to refund. Even if the Commission later determines that the rates were higher than the just and reasonable rates.

Now, this, in effect, is an advance determination by the Commission that it will serve the public interest to announce that it will not suspend and make subject to refund the new rates filed by -- new rates in the new small producer contract, but, rather, will limit itself to acting prospectively under Section 5 of the Natural Gas Act to reduce any rate that it concludes is unreasonably high.

Under the Commission's plan, its review of the reasonableness of the small producers' rates will take place not in a producer proceeding, but, rather, subsequently in a pipeline proceeding.

Under the plan, the pipelines are authorized to track the increased rates resulting from the new small producer contract.

The tracking proceeding in which the pipeline seeks to pass on the increased rate to its customers is the one in which the Commission will determine the reasonableness of the underlying small producer rate.

The pipeline is required under the orders to show that its operating expenses, all of its operating expenses, in this case particularly its purchased gas costs, are not unreasonably high.

QUESTION: I gather, then, if in the pipeline proceeding it's determined that the small producer rates are too high, there's no requirement that the small producers refund.

MR. EVANS: That's right, there's no requirement that the small producer refund to the pipeline. On the other hand, if the determination is made that the rates are unreasonably high, the pipeline is not permitted to pass on those increased rates to its customers.

This serves as a bond of protection for the ultimate consumer, who thereby avoids having to bear the brunt of any unreasonably high rates.

QUESTION: Judge Fahy disagreed with that, didn't he?

MR. EVANS: Well, Judge Fahy concluded that it would be appropriate to strike the no-refund aspects of this order. But really that would destroy the heart of the program, because the no-refund assurance to the small producer is what the Commission is hoping will give him a sense of security in his current revenues that will permit him to make the planning that's necessary, and at the same time it has the very important function of giving an incentive to the pipeline to bargain the prices down.

What the Commission has done is freed the small producers and the pipelines to negotiate rates higher than the area maximum, but they want to leave some bite to the market forces that would otherwise be applied. And if the pipeline is sure that it could always either pass on its rates that are increased or get refunds, if they're ultimately determined to be unreasonably high, it has a free passage and it needn't be terribly concerned about the rates, barring, you know, the ultimate consumer -- if he's running into problems with other forms of energy, of course, he's got a different problem at the end of the line.

But ordinarily he's not going to be in that situation.

So the no-refund assurance is really at the very heart of this program, and without it I don't think the program has, at all, the meat that the Commission intended it to have.

Well, the result of the features, ~~that~~ as I've described them, is that the small producer is assured that his current revenues are not subject to refund, so that he can rely on them in making his plans for exploration. The pipeline which faces this risk of absorbing the losses, if it enters into contracts to run reasonably high, has an incentive to bargain the prices down.

And finally, the consumer whose protection the Act is principally designed to assure is fully protected because there's no -- because no unreasonably high small producer rates will be permitted to be passed on by the pipeline.

Now, the plan is, without doubt, an experimental one. And the Commission intends to monitor closely the results under the plan.

In particular, it stated, at page 145 of the Appendix, that if it finds the program is adversely affecting the interests of consumers, it will take appropriate corrective action.

The Commission's plan is attacked on a variety of grounds, but they can properly be reduced, I think, to three.

QUESTION: Is there a definition of small producer?

MR. EVANS: Small producers, Mr. Justice, are defined -- I'm not sure where in the order; but they are defined similarly the one they were defined in the Permian case to include all --

QUESTION: Footnote 5 on page 6 -- page 5; footnote 3 on page 5 of your brief.

MR. EVANS: Oh.

They're defined to include all producers whose annual sales in interstate commerce are below the level of ten million Mcf, that is thousand cubic feet, of natural gas.

The first argument that's made against the validity of the Commission's order is that it abandons the statutory standard of just and reasonable rates. And this is the basis upon which the Court of Appeals relied in setting aside the order.

The second argument is that the Act does not permit rate review in this indirect manner, that is, postponing the review until the pipeline proceeding.

And, finally, it's claimed that the plan is unfair to the large producers and pipelines who purchase gas from small producers.

The Commission's order specified that its review of the small producer, the reasonableness of small producers' rates in the pipeline proceedings would be in accordance with a standard that I think it might be worth looking at closely.

It appears at page 142 of the Appendix. It's stated that, slightly below the middle of the page, that the standard will be whether or not the small producer's rate, that is, the increase that the pipeline seeks to pass on, "is unreasonably high considering appropriate comparisons with highest contract prices for sales by large producers or the prevailing market price for intrastate sales in the same producing area."

The Court of Appeals thought this was a departure from the statutory just-and-reasonable standard, because it erroneously assumed that the Commission was tying its reasonableness determination exclusively to the two market factors that the order mentioned; namely, the highest contract prices and the prevailing intrastate rates.

Neither of which, of course, the Commission regulates.

This reliance upon this reading of the order is made clear by the Court of Appeals at page 12a of the Appendix to the Petition.

We don't take the position here that an order tying reasonableness to those factors would never be appropriate. In fact, this Court in Permian suggested that in proper circumstances it might be appropriate.

But we do say this is not what the Commission did in this case.

The order does not suggest that the two factors that the Commission identified would be the only ones that would be taken into consideration. The standard is one of unreasonableness -- whether the rate is unreasonably high, and the Commission emphasized that it would consider all relevant factors.

QUESTION: Well, the order isn't all that clear, is it? It takes a little bit of argument about it.

MR. EVANS: I think that's right. It's not the model of --

QUESTION: At least the Court of Appeals couldn't read it like you suggest it to be read?

MR. EVANS: That's right.

You say the Court of Appeals --

QUESTION: The Court of Appeals didn't read it like that.

MR. EVANS: They didn't read it that way, but I think it was an incorrect reading.

QUESTION: Well, why does the Commission object to putting it another way?

MR. EVANS: Well, the Commission believes that this --

QUESTION: I mean, if -- I suppose the Court of Appeals might come up with a different result if you said plainly in your order what you claim the order says.

MR. EVANS: Well, the Commission certainly had that option at one point -- it doesn't have it at this point.

QUESTION: It certainly doesn't, no.

MR. EVANS: But there is a substantial problem of delay here. The Commission believed that the order was clear enough and that there was no need to remedy any ambiguities after the Court of Appeals' opinion.

And to take it back and start all over would --

QUESTION: I suppose this is one way of saying what it means. I mean you're now saying this is precisely what it means and --

MR. EVANS: That's one way. This Court, in --

QUESTION: -- there's no use sending back now that you've said what it means.

MR. EVANS: Well, in a sense, there's no, you know, if the Court construes it the way we suggest it should be construed, that's what the order means.

QUESTION: This thing began in 1970, didn't it?

MR. EVANS: That's right.

Well, while there is some ambiguity that I have to concede, it seems to me reasonably clear that while prevailing market prices are unquestionably among the factors that are to be taken into account, the Commission has not indicated that it is the only, the only considerations that will be taken into account; and for that reason it's not, the standard is not an abandonment of the statutory just-and-reasonable standard.

A second issue is where there is anything in the Act to prohibit the kind of indirect regulatory scheme that the Commission adopted in this case.

The respondents argue that the Act requires direct review in a pipeline proceeding, but they have pointed to nothing in the Act that so specifies. And this Court has repeatedly held, in Power Commission cases, that under the just-and-reasonable standard it is the result that matters and not the regulatory method that's used.

Since this scheme, in our view, is reasonably designed to result in just and reasonable rates, it does not matter that the indirect method is the one that is used, and it does not matter that the Commission has departed from its prior practice of viewing these matters in direct proceedings, in producer proceedings.

In fact, this Court, in the Sunray DX case, in 391 U.S., upheld the similar indirect regulatory scheme. The issue there was whether the Commission was required, under the Act, to consider, in a producer certificate proceeding, whether there was a public need for the gas contracted for.

The Court upheld the Commission's determination that the question could more appropriately be considered in a pipeline proceeding. And the Court held that the Act requires no more than that there be an adequate forum in which the issue is to be ventilated; and that a pipeline proceeding was an adequate forum in which to ventilate it.

Finally, the pipelines argue that the Commission's plan will be unfair to them, because it will impose upon them what they refer to as new burdens and new risks, and because the reasonable standard articulated in the order, in their view is too vague.

The fact is, however, that the pipelines have always borne the risk that an operating expense will be deemed by the Commission to be unreasonably high. In the past the Commission has not required special justification of purchased gas costs, because it was clear at that point that the costs were reasonable, the Commission having already made that determination.

But there is no reason to think that the pipeline has, by virtue of this practice and tradition, become insulated to closer scrutiny of those purchased gas costs, where their reasonableness has not been determined in advance.

The Commission here has not invented a new burden or a risk, it has simply highlighted an existing one. There's no question that the pipelines would be happier were they guaranteed the right to pass on any rates that they were able to negotiated with --

QUESTION: But you -- the Commission doesn't contend that the order would permit refunds, if you -- your regulation is going to be wholly prospective, I take it?

MR. EVANS: With respect to the producer rates. It does permit refunds if the pipelines file for an increased or --

QUESTION: Oh, I understand that.

MR. EVANS: Yes.

QUESTION: That maybe the pipelines are on the hook.

MR. EVANS: Yes.

QUESTION: But the producer, if you determine that the producer has been charging an unreasonable rate to the pipeline, you've committed yourself, apparently, not to order any refunds.

MR. EVANS: That's correct. Now, that does not --

QUESTION: Even though the rate is determined to be unreasonable.

MR. EVANS: Right. And, you know, the Act does not require the Commission to order refunds in any case. It's wholly within the Commission's discretion.

QUESTION: Yes.

MR. EVANS: I don't even believe it's a matter that can be reviewed by the courts, whether, in a particular case, a rate should be suspended and made subject to refund.

And what the Commission has done here is made that determination, exercised its discretion with respect to a class, for sales.

QUESTION: What about under the Federal Power Act, is there any independent cause of action for refund by a consumer or a pipeline?

MR. EVANS: You mean under the Natural Gas Act?

QUESTION: Yes, the Natural Gas Act.

MR. EVANS: I don't believe there is. I frankly confess ignorance. I've never seen one, so I assume there's not. I believe the Commission --

QUESTION: If there was, it wouldn't do you much good to say that we're not going to order any refund.

MR. EVANS: Well, I think that's right, except, I suppose, the Commission could, by rule, make -- oh, for an independent? No, I agree. But I don't believe that there is such a private --

QUESTION: In the railroad business there's an independent you can sue for it?

MR. EVANS: Right. I believe that the only way that the refunds can be ordered under the Natural Gas Act is by the Commission, in a proceeding under Section 4(e) of the Act. I know of no other basis for refunds.

Finally, the pipelines claim that the standard is too vague for them to apply. But that claim really is, in the present posture, one that could be made with respect to any standard that has not yet been applied. In fact, the statutory just-and-reasonable standard could be certainly attacked on the same ground, as being too vague.

The problem is we're dealing with the standard in the abstract, and the Commission has indicated two of the factors that it will take special account of in making its reasonable determination.

The only way to find out whether the standard is really clear enough to be workable is to let it be put into practice to see what happens. The Commission, of course, must be judged in the end by the justness and reasonableness of the results that ensue under the Act. But it's not at this point, there is no reason to anticipate that the standard here will be so unworkable that the Commission should not be permitted to put it into effect on an experimental basis.

MR. CHIEF JUSTICE BURGER: Mr. Vaughan.

ORAL ARGUMENT OF BEN F. VAUGHAN, III, ESQ.,

ON BEHALF OF DUDLEY T. DOUGHERTY, ET AL.

MR. VAUGHAN: Mr. Chief Justice, may it please the Court:

I represent eight individual small producers, none of whom sell more than 2 million Mcf of gas a year at prices ranging from 14 to 24 cents.

The point which is central to this case, and apparently concerns this Court most, is the risk of a refund obligation existing, and yet not being paid by the party who received the money. That certainly is the crux to the case.

What, then, is the risk that there will be a charge by a small producer that is too high?

And then we must look to the position of the small producer --

QUESTION: Where would the refund obligation ever come from if it weren't imposed by the Commission?

MR. VAUGHAN: It -- Your Honor, it may be brought in action by a public service commission, but it must be brought in the forum of the Commission, and must be brought by the Commission.

QUESTION: Well, if the -- what's the source of the obligation to refund, only if the Commission orders it, isn't it?

MR. VAUGHAN: Only if the Commission determines that rhe rate that was charged was unjust or unreasonable, Your Honor.

QUESTION: Well, I know, but does it automatically follow that there's a refund obligation if the rate is determined to be unjust and unreasonable?

MR. VAUGHAN: Not at all, Your Honor. It's for the Commission's discretion, and, indeed, the court, this Court denied certiorari in a case called Prado Oil Company, in which the Commission had taken equitable factors into consideration, and had not --

QUESTION: Well, there's never going to be any -- under this order there's never going to be any refund obligation, then?

MR. VAUGHAN: No, Your Honor, and I would suggest to the Court --

QUESTION: Then there's nothing that --.

MR. VAUGHAN: Beg your pardon, Your Honor; please finish your question. I --

QUESTION: I would suppose you could restate the worry as being that maybe there ought to be a refund obligation; is that what you're suggesting?

MR. VAUGHAN: Yes. It appeared to me that the Court was worried that there should have been a refund obligation. And it's my suggestion that the market position which is occupied by the small producer will produce a rate which the Commission could reasonably conclude would be a refund for, that the market price should be the refund for, where it is reviewed continuously by the Commission albeit prospectively. That the incentive granted by permitting the small producer to receive his market price will enhance the exploratory effort of the small producer and at least it could so be determined by the Commission that this enhancement would transpire.

The small producer does not have, either historically or under the terms of Order 428, the power to charge whatever price he likes. Historically, the small producer leases land, or sub-leases land, it's called farming out, from the large producer. He is offset by the large producer.

He takes the land and does the drilling, and earns a small portion of the acreage that the large producer has. If he's successful in his exploratory well, the large producer then drills developmental wells offsetting him. A pipeline comes to the large producer, who is directly regulated, and says: Will you sell me your gas? The large producer says yes.

He comes to the small producer with the same rate. He says: Will you sell me your gas? The small producer says no.

The pipeline says: Fine, we'll just drain you by buying it from the large producer.

He has no market if he doesn't agree.

Secondly, --

QUESTION: Mr. Vaughan, what is the economic reason that, as Mr. Evans stated, eighty percent of the exploratory work is by this small producer rather than the large one, theoretically the small one doesn't have the funds to do this?

MR. VAUGHAN: Why does all this transpire?

QUESTION: Yes.

MR. VAUGHAN: Well, Your Honor, it -- for one -- I think two basic reasons. One is, is that the large producers tend to hunt for big game; and another phenomenon that transpires in the industry is that the geophysical techniques, the science of oil exploration, does not yield and has not yielded an increased success ratio over the years. They are finding the same number of wells per -- some number of productive wells per wells drilled now that they were in the Twenties. And the large producer says: Small producers, you go out and drill, we'll invest our capital in large lease blocks. So that if you do find something, then we can spend all our money in development.

The second class of gas, of course, is your flowing gas; and the contract prices now prevail for flowing gas for small producers.

But if we look at how much of the contract prices will exceed the directly regulated just and area rates, we will see that there is only about 25 percent of the contract provisions which permit the gas of the small producers, indeed the gas of all producers, according to the study, gas of all producers to exceed the just and reasonable area rates.

And it is this increment, this 25 percent increment, of the small producer production, or approximately three percent of the total gas, upon which the small producer must rely to finance his exploratory efforts.

I thank the Court.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Vaughan.

Mr. Boland.

ORAL ARGUMENT OF CHRISTOPHER T. BOLAND, ESQ.,

ON BEHALF OF INTERSTATE NATURAL GAS ASSOCIATION

OF AMERICA.

MR. BOLAND: Mr. Chief Justice, and may it please the Court:

I'm representing the Interstate Natural Gas Pipeline Association of America, which includes in its membership virtually all the major pipelines in the United States.

I'm also arguing for the major producers in this case.

Mr. Schiff, who is the general counsel of the New York Public Service Commission, will follow me.

We have a rather unusual situation here, and this may be a first. The first time in my memory that the three segments of the industry are unified. We find the pipelines, we find the major producers, and we find the consumers, represented by Mr. Schiff, all unified in their attack against Order 428 issued by the Commission.

Now, I'd like to make one point very clear at the outset. No one of us is opposed to giving the small producer a higher rate. We think that based upon a proper record that the Federal Power Commission may well justify a higher rate which is just and reasonable for the small producer under the circumstances.

But such is not the case here. There is no record in this case. There are a few comments and a transcript of an informal conference. And that's all we have.

Now, our friends here in the government have told us in their reply brief that the issue is not whether the FPC can exempt the small producer from the Natural Gas Act, and they say that the Commission hasn't claimed this authority, and they say they don't argue that the statute permits it. And they say that the contention that the Act requires all producer rates to be just and reasonable is beside the point.

Now, the real issue, as we see it, is the exemption of the small producer. And no matter how you twist or turn it, that is exactly what the Commission did in Order 428.

And in its notice, the original notice issued in the rule-making proceeding, it was frankly captioned, "Exemption of Small Producers from Regulation". That's shown in the Joint Appendix, page 1.

The notice also stated that the small producers would be exempt from all the provisions of the Natural Gas Act and regulations, other than an annual report on volume of sales.

Now, this is in the notice.

So let's go to the order. And in the order the Commission told the small producer: We seek to assure the small producers that when he enters into a new contract for the interstate sale of gas, the provisions of his contract will not -- will not -- be subject to change. Close quote. Joint Appendix 137.

Now, we think that these, taken together, clearly indicate that the Commission contemplated an exemption, and indeed the Court of Appeals wasn't misled on this point. But in the exemption the counterpart of the exemption, in order to give some camouflage to some sort of regulation, what they did was to shift the regulatory responsibility from the Federal Power Commission to the pipelines and large producers.

And this, at a time when the pressures are on us as purchasers to pay the market price, they are asking us to substitute our regulation for theirs under the Natural Gas Act.

As mentioned, the two standards in 428 were given as the highest contract price by large producers or the prevailing market price.

Now, we had some problems in the vagueness of these two terms, but much less than we have as a result of the reply brief, filed by our friends here, and I'll get to that a little later.

Now, as to the large producers, they had a third standard, and they had to have a market differential that was prevailing in the area.

But the purpose of Order 428 was absolutely obvious. It was to give the small producers a price in excess of the just and reasonable price. Otherwise, there was absolutely no purpose in the Commission issuing Order 428. It's clear that this is what they had in mind.

And in so doing, and giving these standards, they gave the pipelines what we thought was somewhat of an assurance, they said the standards, these two standards, the standards also provide pipelines with a more concrete guide for their future action than would exist in the absence thereof.

Simply put, the Commission wanted the pipelines to know in advance the boundaries within which they could freely contract the small producers.

As I've indicated, we think that is -- the Order 428 adds up to complete exemption for the small producers. We think that it's in absolute contravention of the clear and unequivocal terms of the Natural Gas Act.

The Natural Gas Act says, Section 4 says: All rates shall be just and reasonable and <u>any</u> rate that is not just and reasonable is hereby declared to be unlawful.

Section 4(d) says: No natural gas company -- and there's no argument that a sale by a small producer here involved in interstate commerce for resale is a natural gas company within the meaning of the Act. Section 4(d) says: No natural gas company shall make any claim of undue preference or maintain any unreasonable difference in rates.

Section 4(c) says: Every natural gas company shall file with the Commission schedules showing all rates for any transportation and sale.

Section 5 is likewise clear. It says: Whenever the Commission shall find any rate charged by any natural gas company is unjust, the Commission shall fix the rate as the just and reasonable rate.

Now, the Commission, in Order 428 -- and that's what we're dealing with here -- relied for its exemption, relied on the fact that Sections 4, 5, and 7, which is the certificate provision, are not mandatory but discretionary. This is what they said in the Order.

They're not arguing that now before this Court. But this is what they said in the Order. That it's not mandatory and they cited Mr. Justice Clark's comments in FPC v. Hunt, and also the Permian case.

Now, Mr. Justice Clark's statement was pure dictum, he was talking about NLRB Act, which allowed the National Labor Relations Board to decide whether or not it would exempt certain types of activities.

There is no such similar provision in the Natural Gas Act. And in the Permian case, the Permian case is no precedent for what the Commission purported to do in 428.

In the Permian case, the Commission had taken small producers, classified them separately, issued a blanket certificate and said: As long as you do not exceed the ten billion cubic feet a year, you don't need any further certificate authorization for your sales in interestate commerce, as long as and only under the condition that your rate to the pipeline purchaser does not exceed the just and reasonable rate.

And that's precisely what the Permian case stands for, and there's no basis at all for the Commission's exemption.

QUESTION: Mr. Boland, --

MR. BOLAND: Yes?

QUESTION: -- what would you say -- what argument would you make if the Order actually said what the Commission says it said?

Let's assume the Order says in plain language precisely what the Commission claims it says?

MR. BOLAND: Are you saying what they claim here?

QUESTION: Yes.

MR. BOLAND: Before the Court?

QUESTION: Yes.

MR. BOLAND: I would say that the Act precludes it.

QUESTION: On --

MR. BOLAND: Absolutely precludes it. There is no way -- what they initially relied on were these two citations in Section 16. And Section 16 is merely a catch-all provision found in many statutes which gives the power to issue regulations to carry out the purposes of the Act, and to classify certain acts to carry out the purposes of the Act.

QUESTION: But they say they haven't exempted anyone, and they say they are regulating them.

MR. BOLAND: They say --

QUESTION: Under this order.

MR. BOLAND: They say they are regulating them indirectly through the pipeline --

QUESTION: And that when and if they find a small producer charging unreasonable rates, they will correct it.

MR. BOLAND: Through the pipeline rates.

QUESTION: Well, that's what they say -- they say that, don't they?

MR. BOLAND: Oh, they said that.

QUESTION: Yes, they said that.

MR. BOLAND: And they say that the standards now, that the market standards are the just and reasonable standards. In our claim we --

QUESTION: They say two of the -- those are two of the factors they take into consideration. That's all they say now.

MR. BOLAND: Well, yes. But going back to --

QUESTION: Well, I want to say -- I want to just accept their order as they said it now, accept the fact that the order means what they say it means now.

MR. BOLAND: I see -- you mean that the "all other relevant factors" really gave them the power to take into consideration all the things that are now --

QUESTION: Well, they say that. They say that, that they do take into -- that they found to take into consideration a lot more than just those two factors. That's what they say.

MR. BOLAND: Yes, they do.

QUESTION: Well now, accept that for the moment.

MR. BOLAND: All right.

QUESTION: Now, what's illegal about their proceeding along this route?

MR. BOLAND: I think that standard is an impossible one for the pipelines to live by.

QUESTION: It may be impossible, but is it illegal under their statute?

MR. BOLAND: Yes, I think it's illegal.

QUESTION: But --

MR. BOLAND: I think in all their decisions, just and reasonable rate does not mean the market price.

Now, that may mean reasonable or prudent, in our opinion there's this vast difference in regulatory statutes and also the decisions of all the courts between a prudent act of a pipeline, let's say, in going out and buying not any -- at a price not in excess of the market; but that may not be the just and reasonable price which --

QUESTION: They say market price is just one factor. They don't say they're going to rely entirely on that.

MR. BOLAND: Well, they did --

QUESTION: Well, but they don't now.

MR. BOLAND: They don't now, that's right.

But what they've substituted for it is, they say that the sophisticated pipeline purchaser, and at the time he's negotiating a contract, that he can ask the producer for his costs.

Now, the Federal Power Commission has been after producer costs for twenty years, and hasn't been successful yet. Notwithstanding this, they have suggested that one of the things that we do is ask the producer for his cost.

Now, that's going to be one of the guides that they would take into consideration at the time they determine whether we have to refund or whether we don't.

They've also said: Okay, the pipeline's need for the gas, the availability of other gas supplies, the amount of gas dedicated under the contract, the rates of other small producers in recent sales. Add what, and wny other consideration that may suggest the reasonableness of the rate.

What kind of a standard is that? What kind of a guideline is that?

And what the Commission has done -- here we are in a seller's market. There is no question that it's a seller's market. There's a terrific demand for gas unmet, and the Commission is shifting the rate responsibility, the regulatory responsibility to the pipeline purchaser in a seller's market, and expects us to regulate the rate so that it will come up with a just and reasonable rate.

Now, we say that that's an impossible task, and one that's absolutely contrary to the clear language of the Natural Gas Act.

QUESTION: And there might be some problems of the pipelines getting together, mightn't there?

MR. BOLAND: Yes, I think there could be problems in pipelines getting together, and the producers are well aware of that.

But, in any event, I've covered the Permian, what's happened here is we've seen a patchwork post hoc by the Federal Power Commission all the way through this.

The first thing that happened was the notice. On the notice there was clear language that the pipelines would be able to pick up any increase for any price paid. They use the word "tracking", that's what tracking means, in our art, before the Commission.

In the order that came out, they said: No, we're going to put indirect regulation, we're going to hold you responsible.

And at this point there was no change in the producer price at all, prospective or otherwise. Nothing!

The first time we came across a reduction in producer price was before the Court of Appeals, in the briefs filed by the government, in their briefs in the Court of Appeals.

But at that time they were still adhering to the fact that the provisions of the Natural Gas Act were discretionary, and that they were recognizing, in effect, that they were exempting the small producers, but within the purview of their powers under Section 16 of the Natural Gas Act.

But now, before you, they've abandoned all that, and they now say: That's all beside the point. That's all beside the point.

Well, we've got a new ballgame here, and what we're now saying to this Court is that the rate ultimately will be a just and reasonable rate and we're not abandoning the standards at all. And the indirect regulation is nothing more than Sunray DX.

Sunray DX had to do with the need for gas, not rates, which is the heart of the Act, as found by this Court in the famous Hope case. The heart of the regulatory scheme is the rate section.

But what they're talking about is a certificate case, where the need for the gas: do you determine that in the pipeline case, or do you determine it in the producer case?

I think that's a totally different, different case than the one we have here, as to the direct rate responsibility being shifted to the pipelines when the clear responsibility is vested in the Federal Power Commission.

We think all of this is contrary to the rule of the Champlin case. We don't think that they can come and patch their order up. We think that this Court will decide this on the basis of 428.

QUESTION: What are you going to say, Mr. Boland, about the current power of the Commission to experiment with the new problems --

MR. BOLAND: I'm glad you mentioned that, Mr. Chief Justice, because this is not an experiment, and they keep talking about this, and Mr. Justice Rehnquist raised the question, well, wasn't this started in 1970; it was.

The notice issued was issued on July 23rd, 1970, and the Order 428 was issued on March 18th, 1971.

That's all -- that's one month short of three years. And there wasn't anything experimental in the Act, I mean in the Order. The Commission didn't purport, is my recollection, to do it on an experimental basis. But even if they had, they've had three years, three years to develop a record, and there is no record in this case to support what they've done.

QUESTION: Has it been in effect during that time, or has it been stayed?

MR. BOLAND: No, this has been in effect -- now, it could be that when the Court of Appeals issued its decision, that might have had a modifying effect on the action, but, notwithstanding that, it's never been stayed. No. The order is in effect.

QUESTION: Well, was the Court of Appeals' judgment stayed?

MR. BOLAND: No. No, Your Honor.

QUESTION: So the Federal Power Commission has been proceeding under this system --

MR. BOLAND: Oh, yes.

QUESTION: -- for three years.

MR. BOLAND: Right. And it's interesting to note, it's interesting to --

QUESTION: Until the Court of Appeals set them aside, I suppose?

MR. BOLAND: The Court of Appeals set it aside, that's right.

But the Commission is still operating under this. And just, just last month almost in anticipation of this argument --

QUESTION: How can they be operating under it if their judgment -- if their order was set aside?

MR. BOLAND: Well, the pipelines are still entering into contracts, and we had one just in January, a trunkline pipeline --

QUESTION: If the Court of Appeals set their order aside, they set it aside, and that judgment hasn't been stayed, has it?

MR. BOLAND: No. No, Your Honor.

QUESTION: Well, have they violated the order -- the Court of Appeals mandate, then?

MR. BOLAND: Well, as far as I know, they haven't done anything one way or -- well, they haven't done anything to indicate that they're not operating under this thing, and, as I mentioned, on July 31st of -- I mean January 31st, almost in anticipation of this oral argument, the Commission for the first time issued an order against --

QUESTION: Was there an application for a stay here?

MR. BOLAND: No. No, sir.

QUESTION: There's never been a stay?

MR. BOLAND: No, Your Honor.

But on January 31st, just last month, for the first time, they issued an order against trunkline, pipeline company, where they filed a tracking increase, and they suspended it. Because the price being paid to a small producer may be unreasonably excessive.

This is the first monitoring that we've seen in three years, of this great monitoring that my friend, Mr. Evans, has indicated.

I see my time is up. Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Schiff.

ORAL ARGUMENT OF PETER H. SCHIFF, ESQ.,

ON BEHALF OF PUBLIC SERVICE COMMISSION

OF THE STATE OF NEW YORK.

MR. SCHIFF: Mr. Chief Justice, may it please the Court:

New York's basic concern in this case is that the Commission's action, which we believe amounts to deregulation of small producers' rates, will result in passing on excessive costs to consumers. And inevitably so under just about any construction of the Commission's order.

But I think it's quite clear that even if one accepts the possibility of indirect regulation through the use of the pipeline proceeding that the Commission's orders don't provide for a determination of the just and reasonable rate.

And, notwithstanding your question, Mr. Justice White, as to looking at the order the way they're now interpreting it, I would at least, for the time being, in my limited time, try to say what the Commission's orders in fact said, and the Court of Appeals construed it quite correctly.

I don't think any amount of rewriting can really change it.

QUESTION: Mr. Schiff, before you get to that, how much of this cost has come to the consumer over these three years?

MR. SCHIFF: I can't answer that, I don't know, there's no way --

QUESTION: Well, what's your --

MR. SCHIFF: -- no way of telling.

QUESTION: Well, what is your complaint?

MR. SCHIFF: Well, --

QUESTION: You say -- you said, you started off by saying: this high cost will be passed on to the consumer. And now you say it hasn't.

MR. SCHIFF: We can't tell exactly what is being passed on, because these rates are not being regulated; we can't tell how much is above the contract prices. The scheme that the Commission --

QUESTION: The pipeline --

MR. SCHIFF: -- the scheme that the Commission --

QUESTION: The pipeline rates you're paying, aren't they? You're paying the pipeline?

MR. SCHIFF: We're paying the pipeline rates.

QUESTION: And those are regulated.

MR. SCHIFF: Well, let me answer those in terms, because -- if you would turn to page 142 of the Joint Appendix, which is the Commission's Order 428, which is under review.

The Commission set a standard. The Commission determined that in order to encourage the small producers to receive more money, and that the pipelines would contract above what had been fixed as a just and reasonable rate for the large producers, that it was necessary to provide the pipelines with some assurance of certainty.

They established the standard, which Mr. Evans has read to you, saying that the pipelines will be subject to refund, or reducation and refund with respect to new small producer sales, but only as to that part of the rate which is unreasonably high, considering appropriate comparisons with the highest contract prices for sales by large producers, or the prevailing market price for intrastate sales.

Now, the next sentence is what I want to concentrate on. It says, "Tracking increases to the extent they reflect small producer prices for new sales above the standard set forth above may be suspended, and if so, will be collected subject to refund."

Now, two sentences later, the Commission says: where there's been a suspension -- now, remember, this is only where it is above the standard, then "The Commission shall consider all relevant factors."

And we don't deny that the Commission may consider the relevant factors mentioned in the Footnote 3 of the government's Reply Brief, but that only comes into play, as the Court below I think recognized, is when the rates are -- that have been paid are above the standard fixed.

Now, the standard fixed is the highest prices paid by -- to a large producer. Contract price. I misspoke, because it's very important. Traditionally, the way the contracting has been done under the Natural Gas Act, at least since Phillips in 1954, pipelines pay or contract at higher prices than the Commission actually allows.

Certainly that's been true since there's been real regulation by the Federal Power Commission.

And what is discernible, as we point out in our brief, from the files of the Federal Power Commission, is that there are -- the contract price may be 20, 30 or even 40 cents above the rate that has been determined just and reasonable.

Now, it is this high price which, I suppose, can be a market standard, but it's an artificial market standard, at that. Which the Commission says: anything up to that, we will allow without tracking, without going through it all. And that is what the Commission's Order does in this thing, and I don't see how the government can say that they have now rewritten it.

They just don't understand their own order, or at least they don't accept the impact of that.

Now, the court -- the courts have traditionally said that the reason for regulation of sales by producers, whether they -- it is direct or indirect, is because the market is not an adequate basis for determining the just and reasonable rates.

At least where gas is in short supply and it's a seller's market, and we most assuredly have the biggest seller's market that there has been since the Phillips case. And Permian is -- which the government promised and sought a conflict with in their petition -- is not inconsistent with that. It's conceivable that there are times when the market may be such that there is a buyer's market, that competition will infact produce a just and reasonable rate, or, indeed, as in Permian, the Commission did look to market prices, to look at how to balance rates between different types of sales.

But there is no suggestion that the unregulated market price could be a just and reasonable standard.

Now, there's another problem with this order. The Commission, in dealing with the pipelines, or in both 428 and 428(b), the Commission said: we have always been able to examine the cost of purchased gas in a pipeline prodeeding, and the costs of other expenses.

And the Commission's order expressly -- if I may for a second -- at page 139, said: "The Commission has ample authority to inquire in these cases into the reasonableness of all operating expenses and to disallow items of cost which are imprudent."

Now, this is very important. Of course, it's true, imprudent expenses can be disallowed. And they sometimes are termed as excessive or not reasonable from the point of view of the purchaser. But that is not the same as looking at it from the point of view of the seller, as to whether a seller's rate is just and reasonable, which is essentially related to costs. At least it's a surrogate for costs, whether it has to be based expressly on costs or not.

On the other hand, the prudency reasonable test is a market test, the very test which is not permissible as a basis for regulation under the Natural Gas Act.

Now, this is no different than when a pipeline purchases steel pipe. The pipeline can't determine what the costs are of U. S. Steel. The question of whether it's prudent or not is a matter of whether the pipeline has exercised reasonable contracting practices and has paid -- hasn't just gone out on the limb and paid much more than it had to under market conditions.

Now, I know of no authority, and this is where I want to get to Mr. Justice White's question of Mr. Boland. I know of no authority under which the FPC could disallow the cost based on anything other -- purchases gas expenses in a pipeline proceeding, on other, anything other than the prudency test. Or reasonableness, from the point of view of the buyer test.

The only exception that I know of, in regulatory annals, is where there is an affiliation in question, where the seller buys from its affiliate. Then you can get to cost.

But otherwise it's a market test. And so that the Commission has to rewrite its order, not only in the first way that we discussed, but also has to rewrite the order on what prudency means; and it has no legal authority to do that.

And this is where the consumer will bear the brunt, because the test isn't the same test.

Now, finally, --

QUESTION: The Commission's order says that: The action taken here, in our view, does not constitute deregulation of sales by small producers. We will continue to regulate such sales, but will do so at the pipeline level, by reviewing the purchased gas costs of each pipeline with respect to small producer sales.

Now, is that just inconsistent with what they said elsewhere in the Order?

MR. SCHIFF: Well, the regulation that they are promising is a regulation of the purchases, and the standard that they're setting is a market standard, which is not the proper standard for what is a just and reasonable price. And the prudency test is not a proper test, and it's the only legal test for determining what is a just and reasonable price.

So they are saying they're regulating, but the practical effect is that the nature of the regulation is precisely the kind of regulation that did exist before this Court's decision in Phillips in 1954. Doesn't change one iota, notwithstanding my friend's comments in their Reply Brief.

But that was not considered regulation under the Natural gas Act. So that I think that's my answer to you, and very basic to it, though, is that there just is no authority, whether it is when our Commission, the New York Commission regulates a distribution company or the Federal Power Commission regulates a pipeline company. There's no basis on which we can disallow costs, simply because they exceed what the just a-d reasonable level would have been for the seller.

It's a prudency test, and that's all the authority that a regulatory commission has, and the FPC can't change it by saying it has some other authority in its brief.

The Commission's order is much more careful as to its authority in this respect, I think, --

QUESTION: Are you suggesting, Mr. Schiff, that if we go along with the Commission, that's pro tanto, a withdrawal from what we held in Phillips?

MR. SCHIFF: I think yes, inevitably so. An issue which is not really here, but --

QUESTION: Well, it is, if what you say is right.

QUESTION: Are you suggesting we go the whole way?

MR. SCHIFF: Well, I certainly do not suggest you go the whole way. I suggest that if you did that here, you'd do it with respect to all of producer regulation, and I suggest that, after 18, 19 years, that this is a decision to be made in Congress. There have been various bills proposed in Congress for deregulation. That, Your Honors, is the proper forum for the attempt to deregulate.

Now, I think this is what the Commission is doing, but this isn't the right forum.

I want to say with respect to existing contracts, that the Commission did not even make a pretense at indirect regulation. Under existing contracts, which may have been below the contract price, the just and reasonable price, they let them go up, let them be passed through, no indirect regulation. I suggest that, contrary to what is said in the Reply Brief of the government, that we properly raise that.

Thank you very much.

MR. CHIEF JUSTICE BURGER: Mr. Evans, you have about four minutes left.

REBUTTAL ARGUMENT OF MARK L. EVANS, ESQ.,

ON BEHALF OF THE FEDERAL POWER COMMISSION

MR. EVANS: Let me respond first to the question that -- what the Commission has been doing in the interim since the Court of Appeals decided the case.

Prior to the decision in the Court of Appeals, the Commission had been issuing certificates under the Order. When the Court of Appeals set aside the order, the Commission ceased issuing permanent certificates under the Order and began issuing what they call temporary certificates, which, in effect, leave the matter entirely open, pending ultimate disposition.

They are -- the certificates that have been issued since the Court of Appeals ruling have conditioned -- have had a condition that the producer will be subject to refund if the court, if this Court ultimately determines that the Court of Appeals is correct.

Along the same lines, it's very difficult for me to understand the argument that we have had three years to experiment. These three years have been years of obvious uncertainty, which is exactly what the Order is designed to eliminate.

Until juducial review is at an end, there is no fair basis for judging whether the order will have the intended effects.

Mr. Schiff has emphasized, to some degree, that the market is -- market prices are not the proper test for just and reasonable rates.

We don't say that that's the case. We don't argue that the Commission has used it. But I might point out that this Court, in the Sunray DX case, said that the true market price is the just and reasonable rate.

The problem with the natural gas industry is that pipelines have traditionally been permitted to pass on their purchased gas costs in the form of increased rates. And, as a consequence, there has been no incentive for the pipeline to bargain the prices down.

Well, the purpose of the Commission's order, among other things, is to give some sense of reality to the market here and make it more of a genuine market.

So, to that extent, we have, we contemplate, the Commission contemplates something approaching a true market price, which would be the just and reasonable rate.

And I might add also that this Court, in Permian, made it quite plain that it was permissible for the Commission to take into account market factors in determining the just and reasonable rates.

Finally, there seems to be a suggestion in Mr. Schiff's argument that the standard of prudence is something that inheres in the Constitution. There is no constitutional requirement that the Commission apply a prudent standard. The constitutional limit is one of confiscation, that's all. The statutory standard is what matters here, and that standard is just and reasonable, and that is the standard that the Commission intends to apply when it reviews the small producer's rates at the pipeline level.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

[Whereupon, at 11:54 o'clock, a.m., the case in the above-entitled matter was submitted.]

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