ORIGINAL

In the

Supreme Court of the United States

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER, V. SHELL OIL COMPANY, ET AL., RESPONDENTS, AND CONSUMER ENERGY COUNCIL OF AMERICA, PETITIONER, V. FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT.	)	No. 77-1652 and No. 77-1654

Washington, D. C.
January 15, 1979

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IN THE SUPREME COURT OF THE UNITED STATES

FEDERAL ENERGY REGULATORY COMMISSION, Petitioner,	:	
v.	:	No. 77-1652
SHELL OIL COMPANY, ET AL., Respondents,	:	and
and	:	
CONSUMER ENERGY COUNCIL OF AMERICA, Petitioner,	:	No. 77-1654
v.	:	
FEDERAL ENERGY REGULATORY COMMISSION, Respondent.	:	

Washington, D. C.
Monday, January 15, 1979

The above-entitled matter came on for argument at 1:34 o'clock, p.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM BRENNAN, 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
JOHN PAUL STEVENS, Associate Justice

APPEARANCES:

HOWARD E. SHAPIRO, ESQ., Solicitor, Federal Energy Regulatory Commission, Washington, D. C. 20426, on behalf of Petitioner Federal Energy Regulatory Commission.

CHARLES E. HILL, ESQ., 600 New Jersey Avenue, N.W., Washington, D C. 20001, on behalf of Petitioner Consumer Energy Council of America.

THOMAS G. JOHNSON, ESQ., One Shell Plaza, P.O. Box 2463, Houston, Texas 77001, on behalf of Respondents Shell Oil Company, et al.

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C O N T E N T S

PROCEEDINGS

MR. CHIEF JUSTICE BURGER: We will hear arguments next in 77-1652, Federal Energy Regulatory Commission against Shell Oil Company, et al., and 77-1654, Consumer Energy Council of America against Federal Energy Regulatory Commission.

Mr. Shapiro, you may proceed.

ORAL ARGUMENT OF HOWARD E. SHAPIRO, ESQ.,

ON BEHALF OF PETITIONER FEDERAL ENERGY REGULATORY COMMISSION

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

These consolidated cases involve the obligations of producers to supply natural gas under the Natural Gas Act of 1938. The case concerns a statement of policy developed in an informal rule-making proceeding conducted by the predecessor of the Federal Energy Regulatory Commission, the Federal Power Commission.

The Commission undertook to determine what standard of deliverability a certificated producer of natural gas is required to live up to under the provisions of the Natural Gas Act. The policy the Commission eventually adopted requires producers of dedicated gas to produce gas they are required to supply under their certificates, under the standard of a prudent operator as that standard is reflected in state laws governing production.

There are two petitions here. The first is the

petition of the Federal Energy Regulatory Commission, which inquires whether the production and gathering exclusion in Section 1(b) of the Natural Gas Act bars the Commission from adopting the "prudent operator" standard as the delivery criterion under the Natural Gas Act.

The second petition is by the Consumer Energy Council of America, and it contends that the Commission has the authority to adopt a deliverability standard that affects production, but it goes on to say that the "prudent operator" standard is an inappropriate standard.

The Court of Appeals held that the Commission was barred by Section 1(b) of the Natural Gas Act, particularly the production and gathering exclusion in Section 1(b), from adopting a "prudent operator" standard. So, the Court of Appeals said that the Commission had gone too far in adopting the standard.

The consumers argue that the Commission did not go far enough and that the "prudent operator" standard doesn't meet the requirements of the Act.

The consumers have, with the Court's permission, conceded three minutes to the Commission in the division of time in this case, so that the Commission would have twenty-three minutes, the consumers seventeen.

QUESTION: Mr. Shapiro, I wasn't quite as clear as you seem to be as to what question is presented by the

Commission's brief, because I realize that the order adopted by the Commission says that "on or after July 30, 1976, all certificates of public convenience and necessity will contain this provision."

And yet, if you turn to page 16 of the brief for the Commission, the first sentence in the first full paragraph says, "The principal issue in this case is whether the Natural Gas Act imposes an obligation on certificate holders which the Commission has jurisdiction to enforce, that they act as reasonably prudent operators in maintaining deliveries to interstate commerce of gas from dedicated reserves."

And you go on to say that this is going to have vital importance for many, many years because apparently it is incorporated by force of the Natural Gas Act in certificates issued prior to 1976.

Is that your position?

MR. SHAPIRO: That is the position, Your Honor.

QUESTION: Well, that's a little different than saying that the Commission was empowered to choose this as a regulation implementing the statute; isn't it? That's saying that the statute required the Commission to do it.

MR. SHAPIRO: Well, essentially, the Commission's position is it has made an interpretation of the statute to define what the standard of deliverability is. What it found in this rule-making proceeding was that there was a great deal

of uncertainty as to just what producers' obligations were to deliver gas. And it concluded in the ultimate decision, Order No. 539-B, that there was implicit in the delivery obligation that exists under Section 7 of the Natural Gas Act, an obligation to maintain delivery that reaches the duty to at least see that there is sufficient gas produced to meet the obligation.

The Commission found that this was implicit in existing certificates and that it was an appropriate interpretation of the statute as the service obligation had been defined by this Court in --

QUESTION: When was the Gas Act adopted?

MR. SHAPIRO: 1938, Your Honor.

QUESTION: And this is an interpretive regulation that was adopted by the Commission in 1976?

MR. SHAPIRO: Yes, Your Honor.

One reason that the question had not come to the fore was because, as long as there was more gas available than could meet -- more gas available than the market would absorb, there was little question that every producer would try to deliver all the gas he could, and market all the gas he could.

When the gas shortage of the late '60s and early '70s developed, there came -- questions began to arise as to just what the duty of the producer was. Now, the Commission's order in this case did not rest on any finding that there had been some diversion of gas from the unregulated -- to the

unregulated intrastate market, from the regulated interstate market. But the Commission did find that there was great uncertainty as to the scope of the deliverability obligation and it undertook to define that. Its ultimate answer was that implicit in existing certificates under this Court's decisions in Sunray and, for that matter, in California v. Southland, was an obligation not simply to sell gas, as a commodity, but also to deliver gas until there was an authorization from the Commission to cease delivering.

Justice Rehnquist's questions have touched on another matter I should briefly mention. In November of 1978, Congress passed the Natural Gas Policy Act. That new statute changes the basis of regulation for the future rather significantly. It extends price control to both the intrastate market and the interstate market.

However, it also expressly continues in effect non-price regulation under the Natural Gas Act for gas previously dedicated to interstate commerce. That gas is, therefore, still impressed with the service obligation that would apply to dedicated gas under the Natural Gas Act, and is still subject to the requirement that it continue to be delivered until abandonment authority is obtained.

The matter is significant because, among other things, pricing under the new statute for gas previously dedicated to interstate commerce is somewhat lower than prices for other

categories of gas.

QUESTION: Do you think the Commission made this point quite as clearly to the Fifth Circuit as you are making it to us?

MR. SHAPIRO: Well, the Natural Gas Policy Act hadn't been passed --

QUESTION: I mean the difference between a simple regulation by the Commission and a provision that is implicit in the Natural Gas Act.

MR. SHAPIRO: Yes, it did, Your Honor. It is expressly stated in their order. What they expressly declared was that they made -- they found this standard to be implicit in existing certificates and they said that this implicit standard should be made explicit in future certificates.

Now, Section 1(b) defines the scope of the Natural Gas Act.

QUESTION: Had the Commission ever taken a different view?

MR. SHAPIRO: The Commission, with respect to its jurisdiction and the nature of the delivery obligation -- certainly not since Sunray. Sunray clarified the nature --

QUESTION: Well, you had taken a far more expansive view in this very proceeding, hadn't you?

MR. SHAPIRO: In this proceeding, the Commission first undertook to adopt, what I would call, a quantitative delivery

obligation.

QUESTION: Was that -- It didn't find that to be implicit in the Act; did it, or not?

MR. SHAPIRO: It found it to be implicit in certificates. It thought originally that it was reflected in certificates and in existing contracts that underlay certificates.

QUESTION: And in the statute, or not?

MR. SHAPIRO: And it thought that it was permissible to impose the standard under the statute.

QUESTION: Permissible, but not required?

MR. SHAPIRO: That's right, not required.

QUESTION: But now the position is that the "prudent operator" standard is implicit in the Act, but that's required by the statute?

MR. SHAPIRO: A deliverability standard is required that assures the maintenance of delivery. And this is the standard the Commission feels is the appropriate standard to achieve that result.

Now, Section 1(b) defines the scope of the Natural Gas Act. It affirmatively states that the Act covers transportation of natural gas in interstate commerce, sale of natural gas in interstate commerce for resale to consumers and natural gas companies engaged in such transportation or sales. It expressly excludes other transportation or sales, local distribution and distribution facilities and -- the exclusion involved

here -- the production and gathering of natural gas.

This Court's decisions in Sunray and in California v. Southland, however, have made clear that the term "sale" as it is used in the statute, both in Section 1(b) and elsewhere, carries with it an additional concept, the concept of service. That service, as applied to producers, is an obligation to maintain delivery.

The Commission concluded, after going through a rule-making proceeding that moved from a quantitative requirement to the "prudent operator" standard, that existing certificates are subject to this implied requirement, and they then defined it. They said that the "standard encompasses the obligation to develop producing properties consistent with lease agreements and with all valid rules and regulations of any federal, state or local government having jurisdiction, and the standard of what a reasonably prudent operator would do with respect to the drilling, completion, work over, [illegible] completion or abandonment of wells."

QUESTION: I take it, the Commission's position is that its view of the "prudent operator" standard is a nation-wide one, and that it is independent of state law?

MR. SHAPIRO: The Commission's view as to the content of the "prudent operator" standard, as reflected in its order -- and I can take it no further than that at this time -- is that it does refer directly to state and local conservation laws.

For example, statutory, regulatory requirements of the state, relating to production.

It also refers to the standard as adapted from the law governing mineral leases between landowners and producers.

QUESTION: Does it have any content other than what it might have under the local law? Does the federal law -- does this rule now just pick up local law,whatever it might be? Is that the extent of it?

MR. SHAPIRO: As far as the Commission has taken it, it does make an obligation under the Natural Gas Act the same duty that the producers are already under to conduct themselves --

QUESTION: As far as you can tell from the order, it imposes no further duty than the state law does?

MR. SHAPIRO: As far as the decision goes at present, that is right.

QUESTION: And so there might be a lot of different duties, depending on what state you are in?

MR. SHAPIRO: Producers would be operating locally in different states and the nature of their duty might vary locally as a result. There may be some difference in conservation requirements. This is just an example of a federal law referring to a state standard.

Now, the producers, themselves, in these proceedings, argue that the Commission should not adopt any standard of

deliverability affecting their production, because they were already subject to a "prudent operator" standard, and the Commission concluded that they knew what the "prudent operator" standard meant since they, themselves, were making this argument and it adapted it to the federal obligation.

QUESTION: But if the state had an allowable rule about what the allowable production was, would the Commission -- Does this case suggest that the Commission can set a different one?

MR. SHAPIRO: No. The Commission was quite careful not to try and set up, as a result of this standard, any requirement that would go beyond or go into conflict with what the state required with respect to production. Any valid state production standard remains in effect today without regard to the adoption of this standard. It was not designed to set up a new standard. It was designed to apply under Section 7, the operating standard that the producers are already under. Now, there was a reason for that. They went to some length to avoid conflict with the state law because, as this Court has interpreted, the production and gathering exclusion in Section 1(b), it has often said that it applies to the physical activity of producing gas, which is in the domain of the states.

The Commission is not trying to set itself up as a super conservation agency or a super production agency. What it is trying to do is to assure the maintenance of delivery under

Section 7 under the Natural Gas Act.

QUESTION: May I ask this question in that connection: The word "develop" is used in the Commission's order. The exclusion from the jurisdiction of the Commission uses the word "production." What's the difference between develop and production, as a practical matter?

MR. SHAPIRO: I don't know that for purposes of this case we would have to treat them as significantly different. The development the Commission refers to and the production the Commission refers to is the development of dedicated acreage that is already subject to a service obligation under the Natural Gas Act. In short, it is gas which has already been marketed. The acreage has been marketed and the gas producer has committed himself to -- has undertaken the obligation to supply gas to a pipeline. He has to continue that supply until he is authorized to abandon. And if it is not depleted, the essence of the Commission is he's got to at least maintain enough production to meet his obligation to deliver gas.

QUESTION: When acreage is committed, does that mean that all of the necessary drilling has been accomplished, or does that lie ahead in the future?

MR. SHAPIRO: I think it sometimes means that there will be additional development. For example, I have seen references -- I have seen leases -- not leases, but certificates with

underlying contracts in which the dedication, in effect, says, "We dedicate all gas that will be produced on this acreage to the service of some particular pipeline."

QUESTION: Well, under this order, is it your view that the Commission could say to a company that had dedicated, say, a thousand acres, "You aren't drilling enough holes to accomplish the deliverability that we think is appropriate, and you must accelerate the drilling of holes" -- or wells, I suppose you would say?

MR. SHAPIRO: What the Commission would look to is whether it would be prudent, under state standards, for the operator to drill additional holes in order to meet his delivery obligation. However, these are questions which are somewhat in the future, since the Commission has gone no further here and got no further than to announce what the standard would be.

QUESTION: Well, Mr. Shapiro, suppose the law said "Keep your nose out of production and gathering, even if it serves some deliverability end." I suppose you would say then Congress just said don't use this means of guaranteeing the service obligation. But you don't think the statute says that.

MR. SHAPIRO: No, Your Honor.

QUESTION: It says that production gathering is not your business, but you say it is your business as long as it serves a service obligation?

MR. SHAPIRO: Yes, sir. The analysis really is that

Section 1(b) -- anything that is within the affirmative grant in Section 1(b), of jurisdiction over sales, is not barred by the production and gathering exclusion. That's what the Court has held in cases like Interstate Natural Gas Co. v. FPC, in 331. The production and gathering exclusion doesn't take away what it affirmatively granted. But if, as we and the Court have held, the term "sales" includes a service obligation to deliver gas, it necessarily has to include an obligation to produce enough gas to deliver, because if there is no production there is no delivery. And if there is no --

QUESTION: But that just leaves the exclusion out of the Act.

MR. SHAPIRO: It leaves in place the state's jurisdiction over the manner in which production will be conducted, and --

QUESTION: But it's enforceable. The thing that is excluded by the Act is then enforceable by the Commission; is it not?

MR. SHAPIRO: It does make the state standard a reference.

QUESTION: There is some rational connection with the service obligation.

MR. SHAPIRO: Yes.

The consequence, otherwise, is to leave an enormous gap in the regulatory scheme that Congress intended to fill.

QUESTION: That may be so, but the Commission hadn't discovered that enormous gap for quite a while.

MR. SHAPIRO: The need for defining it, as I've explained, became more and more urgent in the late '70s.

QUESTION: Of course, it took quite some time for there to be discovered any obligation over producers at all.

MR. SHAPIRO: It took -- It was 1954 before that was fully developed and it was 1964 before Sunray. So this has been a process of gradual development.

Now, the point about the gap is that if you leave the statute where the Court of Appeals has left it, producers retain an unregulated choice as to whether to supply natural gas, because they can say, "We do not wish to produce." If they let their wells --

QUESTION: What if some state dismantled its rules and said, "We're going to deregulate. We are just going to turn the producers loose. We are not going to put them under any conservation orders or anything else"?

Does that put you out of business in that state, as far as any "prudent operator" standard is concerned?

MR. SHAPIRO: I think that in the absence of specific conservation requirements, by statute and regulation within the state, the Commission would look to the general common law applicable to relationships among lessors and lessees, which also implies a "prudent operator" standard and an obligation not to

produce in a way that damages the property or --

QUESTION: So, you suggest that as soon as the Commission decides some state standard doesn't satisfy it, it will go off on its own?

MR. SHAPIRO: No, I think the Commission will look to what are already valid state standards. Now, the law provides, and this Court has held, that some state standards are invalid, because they are irrational, because they are not related to conservation, because they seek to regulate price or embargo shipment. That kind of standard would be invalid, but the Commission has attempted to coordinate its standard fully otherwise.

Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Hill.

ORAL ARGUMENT OF CHARLES E. HILL, ESQ.,

ON BEHALF OF PETITIONER CONSUMER ENERGY COUNCIL OF AMERICA

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

Our basic contention in this litigation is that the Commission has acted contrary to the terms of the Natural Gas Act, by adopting, as the standard and the exclusive standard governing producer delivery obligations under the Act, a body of state law which has been developed in the various producer states for reasons altogether different than continuation of steady and reliable supply of natural gas in interstate commerce.

There is, of course, also a fundamental jurisdictional question here, that is, whether or not the Commission has the authority to enforce those obligations which it, in fact, certificated.

I would like to leave that jurisdictional question largely to our briefs and to the argument of Mr. Shapiro, but I would like to make one comment. That is a comment that focuses on the distinction between what we say the Act requires and what the Commission has done here.

We say the Act requires an extension of the provisions or an application of the provisions of Section 4(d) and Section 7(b) to significant declines in service. That means that the Commission would be interposed between the producer and the ultimate consumer, and would pass upon the justification for significant declines in delivery. That also means that an order from the Commission would not be in the form of an order telling a producer to drill a particular well in this place or take some action in some other place, which might be the case under a "prudent operator" standard. But the order that would emanate from the Commission is basically the sort of order that would emanate from the Commission when a producer currently comes to the Commission and says, under 4(d), "We would like to reduce service," or under 7(b), "We would like to have a partial abandonment."

That is either a yes or a no, "We accept your

justification for a decline in service," or "We don't accept that justification."

So, the orders that we conceive coming from the Commission in the course of applying a proper delivery standard will not embroil the Commission in questions of where a particular well should be located or what action should be taken in the field.

Now, this case takes its significance from the fact that a base network of investment from that of the pipeline to the end user, power plant, factory or consumer, has been built upon the supply obligations under the Natural Gas Act. And these investments and the interests of those end users will be placed significantly at risk if the Commission lacks the jurisdiction to enforce delivery obligations under the Act, or fails to do so under a proper standard.

It is clear from Section 4 and Section 7 of the Act that one of the prime purposes of the Act is to insure a steady and reliable service or supply of gas in the interstate market. This Court has repeatedly recognized that purpose, as recently as last May in the Southland decision, where the Court held that the obligation to continue service, even in the face of terms in a private agreement which may run contrary to that obligation, was nevertheless essential to carry out the purposes of the Act.

QUESTION: We weren't up against any expressed

limitation on the Commission's jurisdiction either.

MR. HILL: That's right, Mr. Justice White.

QUESTION: And the question here is, I suppose, among others, whether this rule, "prudent operator" rule is within the production and gathering exclusion.

MR. HILL: We would like to see that issue cast slightly differently, and that is whether or not --

QUESTION: I don't blame you.

MR. HILL: -- and that is whether or not the Commission has the authority to utilize, and in fact is required to utilize the provisions of Section 4(d) and 7(b) to significant declines in service.

I don't want to defend jurisdictionally what the Commission has tried to do here.

QUESTION: You don't? Suppose they haven't got the jurisdiction to do what the Commission is doing. Where does that leave you?

MR. HILL: Well, my hope is that the Court in deciding that -- I would hope that the Court would decide favorably to the Commission on that issue, but then move on to our issue.

QUESTION: So you are defending that?

MR. HILL: In that sense, yes.

QUESTION: You mean you just weren't going to defend it in your argument?

MR. HILL: That's right.

What the Commission has done here, and what Mr. Shapiro clearly admits, is to adopt wholesale as the exclusive federal standard a body of state law which has been designed to do two things. One, a body of state stautory and regulatory law, which has been designed to place limits on production in order to avoid waste, and another body of state law which has been designed to govern the lessor-lessee agreement.

I hope that we have made clear in our brief, at page 39 to 41 of the initial brief and 12 to 15 of our second brief, that the principles under each of those two bodies of law were not designed to assure a continuation of service and, in fact, in various instances will militate against that purpose.

Therefore, we believe that the Commission has simply violated the Act, or has not followed the Act's mandate by adopting this body of state law.

QUESTION: Mr. Hill, do you believe that some body of law is implicit in the Act, such as Mr.Shapiro has said?

MR. HILL: I believe that building upon this Court's decisions in Sunray and Southland, that there clearly are obligations to continue service under the Act, and that obligation requires a producer, when he is contemplating a significant reduction in service, to come to the Commission and say, "These are the reasons that I cannot meet the production level that I have been providing, and I want the reduction in service under

Section 4(d) or to accomplish a partial abandonment under Section 7(b) of the Act."

QUESTION: But that isn't the reason the Commission gave, is it, for its interpretive regulation?

MR. HILL: Well, the Commission repeatedly refers to the Sunray case and the Sun Oil case in Order 539-B and actually going back to Order 539, and they repeatedly rely upon the Southland case in their briefs before this Court.

So they seem to think that those decisions give them some authority, but they think that authority allows them to reach out and grab a body of diverse state laws and use that as the federal standard.

We say that those decisions don't authorize that and that there is nothing in the Act or the legislative history which would authorize that sort of step to develop a federal service standard.

QUESTION: But you say there is something, either in this Court's decisions or in the statute which authorizes the development of some sort of a federal service standard?

MR. HILL: That's right, Mr. Justice Rehnquist, clearly so.

QUESTION: Clearly in the Act or clearly in this Court's decisions?

MR. HILL: Well, I think it's found in between the two and I think it becomes clear when one imagines the step

past Sunray and Southland.

Shell Oil has argued here that the private contract between the pipeline and producer contains no firm delivery obligation. In that case, one can imagine the next step in the Sunray or Southland situation, where the producer says, "Not that my contract has come to an end and, therefore, I want to stop service, but that my contract allows me to supply whatever I want to supply at my discretion, and for that reason I won't even go to the Commission to get approval under 4(d) or 7(b) for that reduction in service."

QUESTION: Where does that leave the exclusion?

MR. HILL: That leaves the exclusion, or the operation of the exclusion in essentially the same place that it is with respect to the Commission's current application of 4(d) or 7(b). The Commission, currently, when a producer comes in and says, "I would like to abandon this particular field," listens to its justification and decides whether or not that abandonment is in fact justified. If it decides that the abandonment is not justified, it issues an order that says, "No, you shall continue to serve the interstate market."

All we are asking for and all we think the Act requires is an application of that principle to the situation of significant declines during the course of a contract, and during the course of a certificate.

I might point out that in the Sunray case, at 364 U.S.

156, the Court explicitly referred to Section 4(d) of the Act, in saying that its decision in that case did not make the producer a captive of the Commission. The producer always had the opportunity to come to the Commission and ask for a reduction in service under Section 4(d) of the Act.

Now, we believe that there is a third reason why the Commission's activity here has run afoul of the Natural Gas Act; and that is that what the Commission has essentially done by adopting a body of state law is to pull the service obligation out from under a firm federal standard under the Natural Gas Act.

The Commission has resisted our efforts to point to the FPC v. Texaco case in this regard, but we think that the Commission has done essentially the same thing in the service area here that it attempted to do there. There it tried to pull small producer rates out from under the regulatory scheme of the Act and leave them to be governed by free market decisions of the small producer and the pipeline involved.

Here, what the Commission has sought to do is to pull service obligations out from under the Act, and allow those service obligations to be governed by the free market decision between the lessor and lessee.

As this Court indicated in Texaco, that form of price deregulation was not authorized by the Act. I think also this form of service deregulation is not authorized by

the Act.

Now, the Commission does not contest our position on the merits. The Commission does not claim that there is a particular provision in the Act that authorizes this effort to pick up a body of state law and have that be the delivery obligation under the Act. It doesn't point to anything in the legislative history, and it doesn't really point to anything firm in the decisions of this Court which would seem to authorize that rather unusual effort to develop a federal service standard.

Indeed, there are a number of decisions of this Court which have found very heavily upon that sort of patchwork result. And I might, as an aside, point out that at page 17 of our reply brief we cite to a report which lays out the various provisions of state law, and I think the Court from looking at that -- that Commission report that we cite in the Footnote on page 17 -- can see that, in fact, state laws will differ widely in terms of their obligations, the obligations they place upon the producer on questions of allocation, on questions of pooling, on questions of spacing.

So, what the Commission really is doing here is adopting sort of a patchwork solution to the federal service standard.

But, in any case, the Commission does not point to anything in the Act, the legislative history or the decisions of this Court which would seem to authorize this rather unusual

step in developing a federal service standard.

Rather, it says that the decision of the Commission is due great deference from this Court.

Our first response to that is that whatever standard this Court might apply, this standard, this effort is so far beyond the reaches of the Act that it should be set aside. But I think the Court need not go that far in terms of applying a deference standard.

What the Commission has said here is that it is interpreting the service obligations that flow from Section 7 of the Act, and I believe that the Court of Appeals in the Fifth Circuit fully recognized that at pages 3-A and 4-A of our petition for certiorari, where we have reprinted the court's opinion. It is apparent that the court realized that what the Commission was doing was engaging in an act of interpretation. As such, under the past opinions of this Court, I don't believe that that effort at statutory interpretation is due great deference.

The Commission was not here exercising the sort of authority that it has under Section 5 of the Act, which is basically a legislatively delegated, rule-making function. It was simply engaging in statutory interpretation.

Thus, the decision of this Court last term in National Citizens Committee for Broadcasting v. FCC, I think, is inapposite, as are the other opinions which have been cited

by the Commission.

Under the proper standard or review, no undue deference is required here. In fact, seeing this as an effort at statutory construction, it is important to note this is neither a consistent nor a long-standing interpretation. This is not an interpretation that people have relied upon, as was the case in Natural Resources Defense Council v. Train, which was decided by this Court several years ago, and which has been relied upon by the Commission. Nor is it a decision that draws heavily upon a great deal of experience from the Commission. Because, as Mr. Shapiro has admitted, this constitutes, this Order 539-B constitutes the Commission's first effort at interpreting or defining the service standard which flows from the Act. And, as such, in reaching out for this body of state law, the Commission, in fact, justified its action simply by saying that it was doing so because the producers had become acquainted with it.

I submit that that's hardly a sound basis for deference on the part of this Court to a decision of the Commission.

A question has been raised as to whether or not interpreting the service obligation under the Act may pose some problems of retroactivity. I think what the Commission should have done here, what the Commission says it did was to interpret those obligations and, as in the Sunray case, where again the Commission was interpreting a certificate obligation which had

retroactive effect, that statutory interpretation, that defining of the service obligation raises no retroactivity problem.

In addition, as long as the Commission adopts an approach which allows the producer to come in and show justification for declining reserves or declining deliveries, then I think, further, there is no problem of confiscation or unfairness to the producer.

So, in summary, we submit that the Commission has acted beyond the authority granted it in reaching out for this body of state law and defining it as the federal service standard, that its position here deserves no great deference, and that this Court should reverse the Court of Appeals' decision and remand this action back to the Commission for further consideration in light of the requirements of Section 7 and Section 4 of the Act.

Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Johnson.

ORAL ARGUMENT OF THOMAS G. JOHNSON, ESQ.,

ON BEHALF OF RESPONDENTS SHELL OIL COMPANY, ET AL.

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

My name is Thomas G. Johnson, representing Shell Oil Company, and appearing here on behalf of the producer respondents.

In this case, the Court is again asked to reexamine

the distinction between production and gathering, which is excluded from the Commission's jurisdiction under the Natural Gas Act and sale for resale, which is specifically included.

For some twenty years, since this Court's decision in Phillips, this distinction was thought to be clear by the industry and by the Commission. And to read what the Court said in Phillips, in this regard, I would like to quote the following: "In FPC v. Panhandle Eastern, we observed that the natural and clear meaning of the phrase 'production or gathering of natural gas' is that it encompasses the producing properties and gathering facilities of the natural gas company."

Similarly, in Colorado Interstate Gas Company v. FPC, we stated that transportation and sale does not include production and gathering, and indicated that the production and gathering exemption applies to the physical activities, facilities and properties used in the production and gathering of natural gas.

In the Phillips case, the producer had argued that he was in the business of producing and gathering natural gas and that sale for resale was incidental to that business, and therefore was not subject to Commission jurisdiction. The Commission so found, but this Court disagreed and said that there was a distinction between the physical activity, which the producer was engaged in and was excluded from the Commission's jurisdiction, and the sale for resale, which was covered by Commission

jurisdiction.

In this case, the Commission makes exactly the opposite argument. They argue that production is incidental to the sale, and therefore the Commission must regulate production in order to insure that the sale will continue.

That argument should be rejected for the same reason that the producer's argument in Phillips was rejected, and that reason is that it destroys the clear distinction imposed by Congress between production, gathering and sale for resale.

The only other case which this Court has dealt with the distinction between production and gathering and sale is IGI v. Continental Oil Company, the Rayne Field case. And, there again, the Court reiterated this distinction in this language: "We conclude that even though a sale of natural gas in interstate commerce occurs before production or gathering is ended, it is nonetheless subject to regulation." In the context of such a sale, as distinguished from the situation in FPC v. Panhandle Eastern Pipeline Co., to be discussed hereafter, the production or gathering exemption relates to the physical activities, processes and facilities of production or gathering, but not to sales of the kind affirmatively subject to Commission jurisdiction.

This accommodation of the two relevant clauses of Section 1(b), gives content to the national objectives of the Natural Gas Act, as expounded in Phillips, and to the Commission's

jurisdiction to accomplish them, while in no way interfering with the state regulatory power over the physical processes of production or gathering, in furtherance of conservation or other legitimate state concerns.

We believe, Mr. Justice Rehnquist, that the reason why the Commission had never sought to exercise jurisdiction over production activities prior to this case was that those activities were actively being regulated by the states. This was the case even before the Natural Gas Act was passed in 1938. As early as 1931, this Court, in Champlin Refining Company v. Corporation Commission, affirmed the power of the states to regulate production activities.

This places this distinction under another line of cases by this Court, led by Panhandle Eastern v. Public Service Commission, which held that the Congress in passing the Natural Gas Act intended to fill the regulatory gap, which this Court had held in the Attleboro and Missouri v. Kansas gas cases, the states had no power to regulate.

QUESTION: Mr. Johnson, aren't the states still regulating?

MR. JOHNSON: Yes, sir, they are, Your Honor, and we don't believe there is any gap in the regulation.

QUESTION: There wasn't any gap with respect to just production and gathering.

MR. JOHNSON: We believe, Your Honor, that the states

are regulating production activities, and, as I understand, that was the distinction that the Court made in Phillips and Rayne Field cases.

QUESTION: Yes, but at the time the Natural Gas Act was passed, there wasn't any gap with respect to production and gathering, was there?

MR. JOHNSON: No, and --

QUESTION: I mean, had it been held that the Interstate Commerce Commission forbad the states from regulating production and gathering?

MR. JOHNSON: No, sir. I think the states were doing that. Yes, sir, that's my point.

QUESTION: I thought you were saying that the reason the Commission never got around to this until 1976 was because the states were actively regulating.

MR. JOHNSON: Yes, and they still are, Your Honor.

QUESTION: My question is, why did they get around to it in '76 if the states haven't ceased regulating?

MR. JOHNSON: We have a great deal of difficulty answering that question. We don't think they should have.

The Commission argument that regulation --

QUESTION: Didn't change in the market price have something to do with it? I mean the ratio between the interstate price and the intrastate price --

MR. JOHNSON: Your Honor, we believe that this whole

proceeding is a result of an erroneous assumption on the part of the Commission and the consumer advocates that producers will not produce their gas unless the Commission makes them do it. We believe that that argument defies reason, because the only source of income that a producer has is the gas which he produces.

QUESTION: Yes, but isn't it conceivable that he can get a higher amount of income by selling in the local market rather than selling in interstate commerce?

MR. JOHNSON: Your Honor, that argument --

QUESTION: Theoretically possible, at least.

MR. JOHNSON: -- was made before the Commission and the Court of Appeals prior to the enactment of the Natural Gas Policy Act in November of last year. I do not believe it is any longer possible, because the Natural Gas Policy Act fixes a ceiling price for intrastate sales as well as interstate sales. So that, if there ever was any incentive on the part of a producer to withhold gas to receive a higher price, that was removed by the Natural Gas Policy Act.

The consumers make the argument that there are different categories of gas under that Act, and that the producers may somehow adjust gas between those categories.

We submit that's not true. We think Congress went to great lengths to avoid that very thing, and they provided as nearly as they could that producers must continue to produce

gas from existing fields, from existing wells and they can't get any higher price for it.

QUESTION: Of course, the regulation was adopted before the '78 statute was passed.

MR. JOHNSON: That's right. What I am saying is --

QUESTION: Do you rely entirely on the '78 statute for your --

MR. JOHNSON: No, sir.

QUESTION: Well, if we look at it without regard to the '78 statute, is it not possible at the time the regulation was passed that a producer might have had an economic motive for desiring to get out of federal regulation, be free to sell on the local market? It is at least theoretically possible, isn't it?

MR. JOHNSON: Your Honor, the problem with that theory is that once a producer has dedicated his gas to interstate commerce, he must continue to deliver that gas in interstate commerce. We don't contest that. The problem --

QUESTION: Couldn't you have a problem, say, if you drilled another well or made a capital investment of some kind? You might get a return on your investment at the local price, but not get a return on your investment at the interstate price? So, if you are stuck with the interstate market, you just wouldn't make the investment.

MR. JOHNSON: Your Honor, this Court held in Sunray --

and we don't challenge -- that once the gas from a particular field is dedicated to interstate commerce through a contract and a certificate, the producer can't remove that gas. He can't drill another well to that same field, under that same lease and sell it anywhere else. He has to sell it to the interstate purchaser. That's what the law says.

QUESTION: Not if he gets abandonment approval.

MR. JOHNSON: Yes, but the Commission --

QUESTION: Isn't it possible that at one set price level you could get abandonment approval, by not making further capital improvement? I don't know, but it seemed to me it was theoretically possible.

MR. JOHNSON: Your Honor, I believe the Commission's practice has been consistent, over the last fifteen years, of universally denying abandonment in any situation where the well will continue to produce. So, I don't think it is a practical answer to say that the Commission would grant abandonment and allow the producer to sell somewhere else. As a practical matter, they don't do that.

QUESTION: What is your real objection to the present regulation of the Commission?

MR. JOHNSON: Our real objection, Your Honor, is that the Commission is seeking in this proceeding to second-guess the production decisions of the producers. They come about in this way. Keep in mind that a gas field is continually declining

in production. That's the problem with the standard which says the producer must maintain service, because that's usually physically impossible for the producer to do, because the gas field is continually declining and the ability of the wells to produce is continually being reduced.

Now, the question is whether the producer can do something, at some point in time, to delay that decline or defer the loss of production from these wells. And those are very difficult questions. The question usually comes out: If a well loses production, can that production be restored by drilling a new well, or can it be restored by installing pumping facilities to remove the water which has encroached and choked off the gas, or can explosives or acid be used to increase the permeability of the well?

And all of these things are decisions requiring expert judgment.

We think if the effect of this decision is that the Commission supervises all of those production decisions that the producers will be embroiled in litigation before the Commission repeatedly in an attempt to justify their production decisions. We think that's going to detract from the search for new gas supply, which is the only way that the gas supply can really be increased.

QUESTION: You think you can live with the state authorities, but you don't want another level of regulations?

MR. JOHNSON: That's right.

QUESTION: Do you accept the Commission's statement, or representation here, that the rule they have adopted seeks only to implement what each specific state would implement?

MR. JOHNSON: I would answer that in two ways, Your Honor.

I think the Commission is caught in a dichotomy. They say, on the one hand, that there is a gap in regulation, and yet they say that the state regulation is adequate over production facilities. And we certainly do not contest that once the gas is produced we must continue to deliver it to the interstate purchaser.

So, if that is the Commission's position, then there is certainly no regulatory gap.

If the Commission's position, on the other hand, is that there is a regulatory gap, then they must be saying there is something wrong with the state regulation over production activity and we intend to change it. We don't know what those changes will consist of.

QUESTION: I suppose even if the Commission agrees that there was no gap and you believed them, you would still object to another level of regulation?

MR. JOHNSON: Yes, Your Honor, we believe it is unnecessary and we believe it conflicts with the intent of Congress when they enacted the Natural Gas Act, because we think the

Congress intended to leave that regulation over production activities to the states.

It is difficult to see what more the producer can be required to do than what he is required to do under the state standards, which is to operate with due diligence and as a reasonably prudent operator under the circumstances of case. He certainly can't be required to maintain service from the gas fields where the gas has already all been produced. So, the simple explanation which the consumer advocate proposes is an impractical one, because if the field will no longer maintain service, the question the Commission or any regulatory body has to answer is: Why?

And if the reason why is that the gas is depleted, then there is nothing the producer or anybody else can do about it. It is only if the producer has been negligent or has not operated his lease properly that the regulatory body takes some action.

QUESTION: I would like to address your attention to the example the Commission gives in its reply brief, where, assume you are extremely negligent, don't make elementary repairs or maintenance or anything and your supply, therefore, terminates. Do they have authority to prevent that?

MR. JOHNSON: Your Honor, I'll answer the question this way. First of all, we think that example is completely contrary to reason. It doesn't make any sense for a producer

to spend hundreds of thousands of dollars drilling a gas well and then refuse to spend the few dollars necessary to maintain that well, if his only source of income is coming from that well.

Now, we think that the dividing line is this --

QUESTION: But supposing they did it?

MR. JOHNSON: Let me say what I think the Commission can do and what I think they can't do.

QUESTION: I don't mind as long as eventually you tell me what the answer is to the question.

MR. JOHNSON: I am sorry. I didn't intend to avoid the question.

QUESTION: The question is: Assume the third hypothetical the Government has posited. Do they have regulatory jurisdiction to step in in that particular case?

MR. JOHNSON: We believe that the Commission does not have regulatory jurisdiction to require the producer to make additional capital investment.

QUESTION: How about ordinary maintenance? That's the example they give. "Undertake the most elementary maintenance of its production facilities, so they fall into disrepair, with the result that production and hence deliveries cease."

Now, you say that's absurd to think that would ever happen.

My question is: Assuming it did happen, would the Commission have statutory power to say, "No, you've got to do

some maintenance work"?

MR. JOHNSON: I think they would, Your Honor, because the Court of Appeals below said this. They said that the Commission has the power to require producers to continue deliveries where the wells are capable of producing in paying quantities.

Now, if the wells are capable of producing in paying quantities, even given some minor maintenance operation, we believe the Commission could require that that be done.

Now, what we don't believe, however, is that the Commission can require new wells to be drilled or that capital expenditures can be --

QUESTION: How do we know the Commission is going to require anything more than this in interpreting this regulation?

MR. JOHNSON: Your Honor, that's what they said in their order.

QUESTION: That they are going to require you to drill new wells?

MR. JOHNSON: Yes, sir.

QUESTION: They said they would consider that, didn't they? Questions with respect to that were reserved, weren't they?

MR. JOHNSON: Yes, what the Commission said was that "if we find it necessary to maintain service, we are going to require producers to drill new wells or take whatever measures

we find are necessary to maintain the service."

That's what the Commission's Order 539-B says.

QUESTION: The Commission has told us the other day that it assumes it has the power to do that under this order. I understood Mr. Shapiro to say that. He said they hadn't decided whether they would, but that they have the power under this order. If there any argument about that?

MR. JOHNSON: Your Honor, it seems to me that if they are arguing that they have the power and under the Order they intend to exerc se that power at some point in time, they very carefully avoided any discussion of how this jurisdiction will be exercised.

QUESTION: They didn't say just reserve the exercise, but assert the power?

MR. JOHNSON: I think that's right, Your Honor.

But our point is that in discussing whether or not they have the power, the Court should consider how the power should be exercised, is going to be exercised. And if it is going to be exercised in a way that interferes with the state jurisdiction over production activities, then we think it conflicts with the jurisdiction of the state and exceeds Commission jurisdiction.

QUESTION: I am surprised you answered Mr. Justice Stevens with a "yes" on his hypothetical. It is just as much production and gathering. Negligent production and gathering

is negligent production and gathering. It is still production and gathering.

QUESTION: And I thought your whole position was that within the exclusion there was no power in the Commission.

MR. JOHNSON: Your Honor, I think our position is that the Commission has no power to control the production and gathering activity.

I understood Mr. Justice Sevens' question to be limited to a fact situation where it would simply be a matter of turning the valves back on, or to --

QUESTION: That's still production and gathering, isn't it? Where did they get the power to do that?

MR. JOHNSON: Your Honor, I would be very content if this Court would hold --

QUESTION: I know, but you were asked what your position was, and you seemed to say construe the Act to permit the Commission to do that. You apparently agree with the Court of Appeals.

MR. JOHNSON: I agree with the Court of Appeals when the Court of Appeals said that if the well is capable of producing in paying quantities, that the Commission has the power to make those wells -- to require the producer to deliver the gas. In other words, if the producer just turns the valve.

QUESTION: And to engage in some activity that would make the producer have the wells live up to their potential.

Isn't that production and gathering?

MR. JOHNSON: I certainly think if the Commission requires anything affirmative on the part of the producer to produce the wells, that it is production and gathering and would be excluded from their jurisdiction.

I think the difference and the dividing line is the question of whether or not something more is required than simply turning a valve, or whether the Commission is seeking to require the producer to actually, in some way, control its production operations. And we believe that is what is excluded from Commission jurisdiction under the Act.

QUESTION: Mr. Johnson, aren't we talking about situations where reserves have been dedicated under contracts, say, with natural gas pipeline companies? Aren't there contracts obligating producers to deliver gas to the pipelines?

MR. JOHNSON: Yes, Your Honor, the contracts obligate the producer to deliver all of the gas which is produced -- and that's important -- which is produced from a certain field.

QUESTION: Right, but let me follow that up. Suppose a producer was manifestly negligent, as suggested in the hypothetical that you and Mr. Justice Stevens have been discussing, would the party to that contract, say the natural gas pipeline company, have a cause of action under the terms of the contract for failure to perform as required by the contract itself?

MR. JOHNSON: If the contract did require that the --

QUESTION: Do these contracts require?

MR. JOHNSON: Normally, they do not, Your Honor, because the production decisions in the contracts are normally reserved to the producer. And the pipeline is not the body that polices the producer's actions in those matters. It is the state agencies and the lessors in state proceedings which assure that the producer will proceed diligently.

QUESTION: If you represented a pipeline company that had a contract for the delivery of natural gas and you found out the producer was just not spending a nickel on maintenance and repairs and, therefore, couldn't fulfill the contract, you would take no action?

MR. JOHNSON: Your Honor, first, as I said before, I think that's not a realistic example.

QUESTION: I agree with that, but --

MR. JOHNSON: Assuming that the pipeline did have -- that that was the situation, I think it would depend on whether the contract gave the pipeline that power or whether the contract simply said that the pipeline had the right to buy the gas if, as and when produced, as many of them do.

QUESTION: In any event, the royalty holder would have some interest?

MR. JOHNSON: The royalty owner would certainly vigorously prosecute the producer.

QUESTION: And it is almost guaranteed that he would

have the power under his lease.

MR. JOHNSON: There is not any question about that, sir.

Your Honor, if I could close with just one sentence, we believe that the Commission is seeking to assert jurisdiction in an area which is precluded from assertion by Congress, and we think the Court of Appeals should be affirmed.

MR. CHIEF JUSTICE BURGER: Do you have anything further, Mr. Shapiro?

REBUTTAL ORAL ARGUMENT OF HOWARD E. SHAPIRO, ESQ.,
ON BEHALF OF PETITIONER FEDERAL ENERGY REGULATORY COMMISSION

MR. SHAPIRO: One very brief statement, Your Honor.

First, the states do not require production in aid of interstate delivery obligations under the Natural Gas Act. That is the regulatory gap.

Second, the producers have stated the obligation is to deliver only what they choose to produce. If they choose not to produce or they choose not to maintain their equipment, there will be no gas to deliver. Hence, there is no delivery obligation. And that will destroy the -- or seriously undermine the dedication concept recognized in Sunray and subsequent cases.

QUESTION: Do you mean there will be no contract delivery obligation?

MR. SHAPIRO: There will be no delivery obligation

under the statute, Your Honor, because the contract obligation is not what controls under the Natural Gas Act, but the service obligation resulting from the certification of the sale. That's the doctrine of summary.

QUESTION: You are conceding that if they deliberately don't maintain their equipment they don't have any obligation?

MR. SHAPIRO: No, no.

QUESTION: You are saying what's their view of the statute?

MR. SHAPIRO: I am sorry. I misunderstood your question.

There remains a duty under the statute to deliver.

The Court of Appeals, rather inconsistently, said -- this is in the Petition, page 7-a -- "The FERC can enforce 'service obligations' contained in the certificates that it issues to producers, preventing producers from ceasing deliveries from fields admittedly capable of continuing production."

Now, the word "admittedly," I assume refers to admitted by the producer, but if, in fact, the field can produce, and all that is required is the ordinary prudent action to keep it producing, then what the Commission is saying here is simply that they should take those steps to assure that they produce what they have undertaken to deliver. And that is the essence of the "prudent operator" standard.

Finally, the consumers argue that the standard goes

too far. But the standard is designed to accommodate with state law. It is not designed to conflict with it. It does not conflict with it.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

(Whereupon, at 2:34 o'clock, p.m., the case was submitted.)