ORIGINAL

In the

Supreme Court of the United States

FEDERAL ENERGY REGULATORY COMMISSION,	)	
PETITIONER,	)	
v.	)	No. 77-648
PENNZOIL PRODUCING COMPANY, ET AL.,	)	
RESPONDENTS.	)	

Washington, D. C.
November 28, 1978

Pages 1 thru 48

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PENNZOIL PRODUCING COMPANY, et al., :
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Respondents. :
:
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Washington, D. C.,

Tuesday, November 28, 1978.

The above-entitled matter came on for argument at 2:05 o'clock, p.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM J. BRENNAN, JR., Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
WILLIAM H. REHNQUIST, Associate Justice
JOHN PAUL STEVENS, Associate Justice

APPEARANCES:

STEPHEN R. BARNETT, ESQ., Office of the Solicitor General, Department of Justice, Washington, D.C. 20530; on behalf of the Petitioner.

JERON STEVENS, ESQ., Baker & Botts, 3000 One Shell Plaza, Houston, Texas 77002; on behalf of Respondent Pennzoil Producing Company.

APPEARANCES [Cont'd.]:

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

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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 648, Federal Energy Regulatory Commission against Pennzoil.

Mr. Barnett, you may proceed whenever you're ready.

ORAL ARGUMENT OF STEPHEN R. BARNETT, ESQ.,

ON BEHALF OF THE PETITIONER

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

The principal question in this case is whether the Federal Power Commission, now the Federal Energy Regulatory Commission, validly interpreted the Natural Gas Act when it held that it would be inconsistent with the Act for the Commission to approve as a just and reasonable rate above the otherwise applicable ceiling rate, and for the Commission thus to pass through to interstate pipelines and hence to the consuming public incremental royalty costs based on the price of natural gas in the unregulated intrastate market.

Respondents Shell and Penzoill produce gas from a field in Southern Louisiana and sell it in interstate commerce under certificates granted by the Commission to United Gas Pipe Line Company, an interstate pipeline.

The gas is produced by Shell and Pennzoil under leases granted by the landowner/lessor Williams in 1934 and 1952. The 1934 lease provides for royalty to Williams of one-eighth of the value of the gas produced; the 1952 lease provides for royalty of one-fourth of the value of the gas produced. In each case the value was to be calculated at the market price or the market rate prevailing at the well. Shell and Pennzoil had always computed and paid their royalties as fractions of the market rate that they actually received by selling the gas to United. Rates which, since this Court's 1954 decision in the Phillips case, have been set by the Commission.

Thus, in 1975, the applicable Commission rates to the gas in this case were approximately 31 cents and approximately 60 cents.

Beginning in 1973, however, Williams demanded payment from Shell and Pennzoil of royalties based on the market value of the natural gas in the unregulated intrastate market. These values were said by Williams to range from 35 cents to 70 cents per Mcf for the period through mid-1974, and then from 1974 to 1975, from \$1.30 to \$1.40 per Mcf.

When Shell and Pennzoil refused to pay these higher royalties, Williams purported to terminate the leases. Shell and Pennzoil then sued Williams over this question in Louisiana State court. Before the court made a ruling, the parties entered into a settlement agreement contingent on approval by the Commission.

The settlement provides that Shell and Pennzoil would apply to the Commission for permission to pay specified increased royalties to Williams and to pass through these increases to United. The royalties provided for in the settlement were royalties based on -- that is, the appropriate fraction of -- either a price of 78 cents per Mcf, increasing 1.5 cents a year after 1975, or based on a price of 150 percent of the highest rate set by the Commission, whichever was higher; that is, whichever, the 78 cents or the 150 percent of the Commission rate, was higher.

As an alternative, the settlement provided that Shell and Pennzoil would ask the Commission for permission to abandon the portion of the gas that was attributable to the royalty interest, that is one-eighth or one-fourth, so that that gas could be paid to Williams as a royalty-in-kind for sale by Williams wherever Williams wanted to sell it, presumably in the intrastate market.

Shell and Pennzoil then duly took this agreement to the Commission, seeking its approval. The Commission's Administrative Law Judge denied the petition for the special relief for the higher rate that would pass through these incremental royalties to the pipeline. The judge concluded that special relief from an area or a national rate is warranted only when a producer can demonstrate that his overall costs from the operation in question are higher than the Commission's ceiling or that his out-of-pocket expenses will exceed revenues.

The judge found that Pennzoil had made no attempt to make any such cost showing, and that while Shell had made such an attempt, Shell had failed. The judge found in particular that if Shell were to pay royalties based on the 78-cent rate in the settlement, Shell would still make a profit of something like $290,000 a year on the leases in question under the Commission's ceiling; that is, it would not need a higher rate to make that profit.

The judge further found that even if Shell --

QUESTION: In the abstract, those figures really aren't very meaningful, are they?

MR. BARNETT: Well, we think they are.

QUESTION: As compared with what? 390,000.

MR. BARNETT: Well, if the standard is that in order to obtain special relief from a Commission rate you have to show that your cost would exceed your revenues --

QUESTION: You have to show a hardship case.

MR. BARNETT: Well, if you like, yes; then it certainly isn't inequal to show that you are making a profit rather than a loss.

QUESTION: Well, you didn't define what kind of a profit that was. Are you talking about a net clear profit after all costs, and that sort of thing?

MR. BARNETT: Well, after all costs that Shell showed here. Shell was given an opportunity to show whatever costs it could, and, after all costs it showed, the Administrative Law Judge found that it would still have a profit.

QUESTION: Does the record show what their profit would have been if the decision of the Commission was correct?

MR. BARNETT: No, it does not, Your Honor.

Except one can figure it out by adding the incremental royalties to the -- to what the Administrative Law Judge found that their profit would be without it.

In addition to denying the price relief, the Administrative Law Judge also denied the alternative abandonment relief.

The Commission affirmed the denial of the requested rate increase, but on a broader ground than the Administrative Law Judge had taken. The Commission found that the impetus for the settlement is the market value of the royalties, and held that it would be inconsistent with the Natural Gas Act for it to allow the pass-through as just and reasonable rates under the Act of such incremental royalty costs that were based on the market value of natural gas in the unregulated intrastate market.

QUESTION: Mr. Barnett, did it actually take the position that it had no jurisdiction to consider them?

MR. BARNETT: The Commission never said it had no jurisdiction. The Commission did put its holding in terms of lacking authority, that it --

QUESTION: Which is pretty much the same thing.

MR. BARNETT: I don't think it is. Because the Commission did consider the question. The Commission had a full hearing and considered whether it should grant the relief requested, and decided that it should not because to grant it would be inconsistent with the Act.

Now, the Commission phrased that holding in terms of lacking authority under the Act, but the Commission made the decision that it lacked the authority. The holding would be no different if the Commission had simply said: We hold that to grant relief based on incremental royalties based on intrastate markets would be inconsistent with the Act as interpreted by this Court in Texaco.

So while the decision is phrased largely in terms of lacking authority, it's also phrased in terms of being inconsistent with the Act, the Commission decided that it lacked authority, it was a decision made by the Commission; and thus we submit that the question before the Court here is whether this was a valid interpretation of the Act by the Commission.

QUESTION: It decided that it simply could not consider this factor.

MR. BARNETT: It considered this case, and it --

QUESTION: It considered the case, but it could not consider this particular factor.

MR. BARNETT: Which particular factor? I mean, it decided that it could not grant relief for incremental royalties based on the intrastate market. What it decided that it could not consider was whether these particular royalties were reasonably incurred. And the reason it decided that it could not consider that was because it had decided, as a matter of law, that when the royalties are based on the intrastate market, to allow them would be inconsistent with the Act.

The only thing it refused to consider was the particularized question of whether these royalties were reasonably incurred.

The Commission also --

QUESTION: So you are saying, then, that the Commission decided that it would violate the Act for them to grant relief in this case?

MR. BARNETT: Yes. The Commission decided that it would violate the Act as interpreted by this Court in the Texaco case for it to grant relief in this case or in any similar case where special relief is sought based on incremental royalties, based on the unregulated market price.

QUESTION: Is that the position the Commission took in the Court of Appeals?

MR. BARNETT: I am not familiar with the Commission's brief in the Court of Appeals, Your Honor, so I cannot answer that question. I think it is the position the Commission took in its order, in its orders on rehearing.

QUESTION: Do you think the Commission adequately states the reasons for its decision in its opinion?

MR. BARNETT: I think it does. I think there are --

QUESTION: Under your ordinary administrative practices of explaining clearly enough what the grounds for the decision are?

MR. BARNETT: I think it does. As in the previous case, if I were writing, if I were writing the Commission's opinion, just as if I were writing the Act of Congress, I like to think I could do a better job. But I think here the Commission's decision is entirely adequately reasoned by the applicable standards. The Commission made clear, relying on this Court's holding in the Texaco case, that it would be inconsistent with the Act for it to establish as a just and reasonable rate royalties -- a rate that is based on cost based on the intrastate price, the unregulated intrastate price.

QUESTION: So that if someone comes in and just says, "I am now having to pay more for my gas than I used to, and I want a rate adjustment", the Commission says, "We have no power under the Act to grant that"?

MR. BARNETT: Oh, no, no, not at all. The Commission says, "We have no power under the Act to grant it" or "We decide under the Act that we will not grant it"; if the higher costs you are talking about are higher costs that are simply based on the unregulated price of gas. Which the Commission found that the costs here were.

QUESTION: That is simply a factor which the Commission will not take into consideration in deciding whether a higher rate should be granted?

MR. BARNETT: No, no, the Commission took it into consideration here and decided that under the Act that it may not grant the higher --

QUESTION: So they have no power to grant it.

QUESTION: They have no power to grant it.

MR. BARNETT: Well, the Commission decided here that it had no power, yes, based on its interpretation of the Act.

QUESTION: That's all I asked you. Yes.

MR. BARNETT: Well, yes, but the point is that, as the respondents present the case, it's simply a procedural matter and the Commission here has refused even to consider anything. That is not how we think it was. The Commission fully considered the issue and decided, as a matter of law, as a matter of its interpretation of the Act, that to grant the relief would be inconsistent with the Act. It did consider the issue.

QUESTION: We have had two or three cases here in the short time I've been on the Court coming from the predecessor of the FERC; where the Commission has started out taking a position, we simply have no jurisdiction to consider this; and by the time it gets here it turns out they have jurisdiction but they could easily have decided it the way they did on an administrative basis.

MR. BARNETT: Well, that's true. But in this case, Mr. Justice Rehnquist, the Commission never said it lacked jurisdiction; it did use the word "authority". But we assert that the same --

QUESTION: That's just a legal decision.

MR. BARNETT: Yes, it's simply a legal decision. There is no different effect between its saying it lacks authority under the Act and its saying, "As we interpret the Act, it would be inconsistent with the Act for us to do this."

QUESTION: Has the Commission always taken this position or not?

MR. BARNETT: Always in this case?

QUESTION: No. In other cases, similar cases.

MR. BARNETT: Well, this was the first case presented to us that presented this issue, Mr. Justice Rehnquist.

QUESTION: You mean about an independent producer?

MR. BARNETT: About a royalty based on a market value of royalty which was interpreted to refer to the unregulated intrastate market.

QUESTION: What about the cases that Pennzoil referred to, the pipeline cases?

MR. BARNETT: Oh, I'm sorry. You're referring to El Paso and Cumberland; I thought you were referring to earlier cases.

QUESTION: Well, I was. But now I'm asking you about --

MR. BARNETT: Yes. Well, they are distinguishable. The El Paso case involves a pipeline as distinguished from an independent producer.

QUESTION: But the same section of the law.

MR. BARNETT: Well, it's the same section, except that the section that provides -- Section 2.66 of the Commission's regulations does provide, as Pennzoil states, that pipelines as well as independent producers are subject to the applicable ceiling price. However, in fact, El Paso was granted an exception from that provision in the very El Paso case. And under that exception, El Paso's rates were established on a strict cost-of-service basis; that is, established individually for El Paso, so it was not a question of special relief from an otherwise applicable rate.

Now, in the Columbia case, which is also cited, that was a case involving -- where a pipeline made some purchases of gas which were held to be non -- which were previously held to be non-jurisdictional purposes -- purchases. That is, the sale of the gas to the pipeline was not regulated by the Commission, and the question was whether the price that the pipeline paid in that unregulated purchase could be included in the pipeline's rate, and the Commission held that it could.

Well, apart from the fact that it --

QUESTION: Yes, but that was an individual case. There had already been a ceiling price established in Columbia, hadn't there?

MR. BARNETT: I think so, Your Honor.

QUESTION: Well, what's the difference between that case and this one?

MR. BARNETT: Well, I think the difference between that case and this case is that that is a special case involving jurisdictional purchases of gas to -- how else are you going to treat that --

QUESTION: Non-jurisdictional purchases.

MR. BARNETT: I'm sorry, non-jurisdictional purchases.

QUESTION: Well, this is non-jurisdictional here, too.

MR. BARNETT: That's right; the royalties are non-jurisdictional, too. We think there --

QUESTION: Well, what is the difference?

MR. BARNETT: Well, we think the Commission was justified in thinking that there's a difference because if you allow the pass-through of non-jurisdictional market value royalty rates, market value royalties being so common, you are going to completely undermine the regulated rates for the sales that the producers make; whereas, to do it in an individual case like Columbia, those non-jurisdictional purchases would not underlie a whole --

QUESTION: But you're still construing the same section of the statute.

MR. BARNETT: You are still construing the same statute, but the Commission could make the decision that if it granted the relief in the market value royalty cases, it would be undermining the entire regulatory scheme, as this Court pointed out in Texaco, which was another case where a whole regulatory scheme would be undermined, and there is no such effect in an individual case of non-jurisdictional purchases such as Columbia.

QUESTION: So I take it the Commission didn't agree with the Administrative Law Judge?

MR. BARNETT: The Commission did not address itself to the Administrative Law Judge's holding that this case turns because --

QUESTION: Because the Administrative Law Judge thought the Commission had legal power under the statute, that the Commission said it didn't have?

MR. BARNETT: The Administrative Law Judge didn't really address the question the Commissioner addressed, either. He simply said the threshold for such relief is: Can you show that you're operating at a loss? And this has not been shown. The Commission didn't look at that question, it said that --

QUESTION: They just said, "We can't get there", that's it.

MR. BARNETT: It said, "We can't get --

QUESTION: "It's illegal for us to get to that question".

MR. BARNETT: It said that under the Act it would be illegal for us to grant relief in this case. The Commission did not, however, and as we point out in our reply brief, the Commission's holding is not applicable to a case where that kind of a showing was made.

If the producers did show that their costs exceeded their revenues, so that they had made a case for confiscation, the Commission has not addressed that issue. The Commission's decision --

QUESTION: Then suddenly it would be legal to recognize the extra royalty cost gap?

MR. BARNETT: Well, yes, it might be. The Commission here does not interpret the Act to require it to do something unconstitutional, which it would be to impose a confiscatory rate. And thus, again, the Commission decision is an interpretation of the Act as applied to market value royalties based on the unregulated market in a situation that does not present a case in confiscation.

Now, the reason the Commission interpreted the Act this way was largely this Court's decision in Texaco, where the Court made quite clear, as it said, that the prevailing price in the marketplace cannot be the final measure of just and reasonable rates mandated by the Act, and it further pointed out there that while the Commission had said that the rates would be subject to refund if they were unreasonable, reasonableness was apparently to be judged by the standard of the marketplace.

Now, there are one or two factual differences between this case and Texaco, which I assume my colleagues will point out, and which I would therefore like to address.

It is that there are two what I would call quantitative differences only. It is true that in Texaco it was the entire rates of the small producers whose reasonableness was to be judged by the standard of the marketplace. Whereas here the royalties are only a fraction of the market price, one-fourth or one-eighth here, as against the entire market price in Texaco.

Another quantitative difference is that here again you would -- that in Texaco, again you were talking about the entire price charged by the small producers, whereas here the royalty increment is only a portion of the price that the producers would be charging the pipelines.

We submit that neither of these quantitative differences changes the applicable principle.

The second difference can be readily dismissed as a matter of law, because the incremental royalty here, even though it's only an increment, even though it would only be a part of the price the producers charge the pipeline, was the entire rate that the producers are asking the Commission to approve as just and reasonable. It was the entire incremental royalty that had to be shown to be just and reasonable, and thus the Commission's refusal to find it just and reasonable, and the Commission exactly said as much, that it had to find the entire incremental royalty to be just and reasonable, is completely consistent with Texaco.

Now, the other difference, one-fourth and one-eighth versus the whole thing, is again clearly not a difference in principle. The Cout said as much in Texaco, 417 U.S., at 399, where it said, "Even if the effect of increased small producer prices would make a small dent in the consumer's pocket, when compared with the rate charged by large producers, the Act makes unlawful all rates which are not just and reasonable and does not say a little unlwafulness is permitted.

Thus it's true of the incremental rate that the producers want it passed through here, just as it was true of the rate in Texaco, that it would be judged exclusively by the market prices; and thus we submit the Commission was entirely justified in relying on Texaco for its conclusion that it would be inconsistent with the Act to allow the pass-through as a just and reasonable rate of royalties based on the unregulated market.

Another reason for the Commission's decision is pointed out by the effect of the Court of Appeals decision below, the decision that we ask the Court to reverse. Respondents attempt to address that decision in sheep's clothing, and argue that it is simply a procedural issue that's at stake here, seizing on the Commission's language about authority, and thus, for example, Shell says in its brief, "The Court of Appeals did not require the Commission to find for the producer; the Commission was merely required to consider the merits of the producer's position."

Well, that sounds fine.

The short answer, first, is that the Commission here did consider the merits of the producer's position. It did consider thwether it should grant the producers the relief they seek, and it decided not to. It decided that it would not do so, it could not do so, because to do so would be inconsistent with the Act as interpreted by this Court in

Texaco.

But, further, the fact is that the Court of Appeals decision clearly would require the Commission to grant relief and not simply to consider doing so.

For example, the Court of Appeals said -- this is on page 7A in the Appendix to the Petition -- "This is not to say that every additional cost must be passed through to the customer to protect a producer's level of profits. The Commission has authority to consider the reasonableness of any costs incurred."

But the kicker is, under the ad hoc reasonableness standard, the Commission would be required to find the cost to be reasonable in any case of a market value royalty that was held to apply to the intrastate market. Shell and Pennzoil, when they depart momentarily from their minimalist portrait of the decision below, admit as much. They argue that the Commission would be required to grant them relief for several reasons: that these leases were entered into before the Natural Gas Act, or before Phillips, that the royalty provisions were consistent with the industry standards at the time, and that the price increase would generate no process, since it would simply be passed through.

Well, that would be true generically, typically, of market value leases in any State where such leases have been held or might be held to refer to the intrastate market.

Thus, if all the Commission could consider was whether a particular royalty had been entered into reasonably, it would have to find that it was. And thus, what's at stake here is not simply a procedural issue but whether the Commission muast grant relief on a generic basis for such market value royalties, and the Commission held, consistently with Texaco, that it may not do so.

I'd like to reserve the balance of my time.

QUESTION: Mr. Barnett, before you sit down --

MR. BARNETT: Sure.

QUESTION: Your reply brief filed yesterday reached my desk just this morning.

MR. BARNETT: I'm sorry, Mr. Justice Blackmun, we filed it in typescript with the permission of the Clerk last Wednesday. We did have a printing problem.

QUESTION: I am not being critical, I merely would like to have you make a one or two-sentence comment on the effect of the '78 Act. Because it seems to me that the new Act makes the underlying rationale of Texaco almost inapplicable from here on in.

MR. BARNETT: Well, we don't think it does --

QUESTION: You tried to downplay it in your brief, but maybe I should ask this question of opposing counsel; but at least I'd like some comment from you.

MR. BARNETT: Well, we don't try to downplay it, we

-- that is, the Commission's view of the impact of the Act, the Act has a considerable impact in many ways. However, as we point out in the brief, the ceiling price provided by the new Act for gas that was already dedicated to interstate commerce under the old Act would remain the ceiling price that had been set by the Commission, as adjusted for inflation, or that had been increased by the Commission under the just and reasonable rates of the new Act.

Thus, the prices applicable to this gas under the new Act are based on the prices applicable under the old Act, and that, very briefly, is why we think the issue is still alive and needs decision; although, admittedly, in the future, as the two markets converge, the practical significance of the issue may be expected to decrease.

Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Stevens.

ORAL ARGUMENT OF JERON STEVENS, ESQ.,

ON BEHALF OF RESPONDENT PENNZOIL

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

I must say that I've been increasingly intrigued as this case has developed on its way from the Fifth Circuit Court of Appeals, particularly in the position that the Commission has been taking. I didn't prepare these remarks to begin this way, but let me take a few minutes of my time and tell you why I'm so intrigued.

That is, the Commission in its opinion, in the opinion in the case below, said, and I quote: "We cannot permit any incremental royalty cost resulting from this settlement or resulting from any judgment by a State court regarding royalty payments to be passed on to the pipeline, if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate."

They did not say, "we cannot permit any rate based on intrastate rates to be passed on"; they said, "any factor other than the just and reasonable rate." And of course there are a number of other factors that should be involved in any case like this, and they are involved in the case below, that we had witnesses about it and all that.

The interesting thing about this is the Commission decided it had no authority. This case was tried in the Fifth Circuit as a question of authority.

QUESTION: Well, I know, but that's an ambiguous term, too, I suppose.

MR. STEVENS: Jurisdiction, if you will, Your Honor.

QUESTION: Well, there's no word about jurisdiction in its opinion.

MR. STEVENS: I agree, and that's why we've used the word "authority".

QUESTION: And there isn't in the -- and the Court of Appeals didn't refer to it as jurisdiction.

MR. STEVENS: No, sir; I certainly agree with that.

QUESTION: And you could sensibly call it a matter of authority if the question was, Is it legal under the Act?

MR. STEVENS: Yes, sir.

QUESTION: Well, suppose to do what the Commission was asked to do was illegal under the Act, you could say they have no authority to grant it.

MR. STEVENS: That's the word I would use. I certainly agree with that.

The interesting thing about it, though, is that, as the record below shows, the settlement in this case -- it was a settlement of royalty litigation under market value lease -- the settlement tied the royalty to either 78 cents or 150 percent of the national rate. At the time the settlement was executed, the Commission had before it, in a rule-making proceeding, a proposal to permit small producers to collect 150 percent of the national rate.

This settlement was tied exactly to that. At that time the national rate, as reflected in the record below, was 52 cents per Mcf; and 78 cents is exactly 150 percent of that.

This settlement was tied directly to Commission-set rates and not to intrastate rates.

Unfortunately, the only direct testimony in this point was produced by Pennzoil's witness Gray, and is found at page 36 of the transcript in this case, which, because of the way the case was briefed in the Fifth Circuit, is not in the Joint Appendix. But of course it is available to the Court, and, should the Court wish, we'd file that as a supplemental appendix.

Those are the facts of how that case got to the Fifth Circuit.

Now, we've been seeing this evolving argument, and it comes out very expressly for the first time at page 12 of the reply brief that was filed last Wednesday, when the Commission finally makes the assertion that the Commission based its decision -- and I'm sorry, Your Honor, I'm talking about the typewritten copy and not the printed copy.

QUESTION: We don't usually get the typewritten copy. What's the --

QUESTION: Well, what's the argument? Maybe we can find it.

MR. STEVENS: That is that the Commission based its holding on the record to the effect that this settlement royalty was based on intrastate rates. That is just not the fact.

If that is now the argument that the Commission is relying on, then I suggest that they have a serious problem under Section 19(b) of the Act, because that would be a factual finding, and,as I read Section 19(b) of the Gas Act, it requires all factual findings to be supported by substantial evidence. And there's not only no substantial evidence, there is no evidence on this --

QUESTION: Well, but do you suggest that what the government argues here in its reply brief, or elsewhere, does not gee with what the Commission itself found in its opinion?

MR. STEVENS: Yes, sir, I suggest exactly that.

QUESTION: So you're saying that they want affirmance on a ground different from what --

MR. STEVENS: Yes, sir.

I'm suggesting exactly that.

QUESTION: Well, would you follow that by saying that we can't reach a ground not considered by the Commission?

The Court has held that, 20-odd years ago.

MR. STEVENS: Well, Your Honor, I'm certainly aware that this Court has held that it would be improper to -- in the Burlington Trucking case -- to affirm a Commission decision based on post hoc rationalization. And, yes, sir, I'm suggesting, if that's the basis of their primary thrust of their argument at this point, that the Court cannot and should not affirm it on that basis.

Now, if the Court wishes to affirm it on the question of authority, which is what we briefed in the Fifth Circuit, argued there, and I thought we were arguing here, then of course the Court is free to do that, because the Commission did address that issue also.

And I would suggest that the basic reason that the Commission has reached the position that it's in in this case is because it did read Texaco, but it misread it.

We read Texaco as being a case basically where the Commission was attempting to deregulate small producer rates, by tying them directly and solely to intrastate practice.

We read Texaco as holding that the Commission cannot deregulate something over which it has direct jurisdiction, but that if the Commission wishes to regulate indirectly, it must consider all factors and not solely intrastate price levels.

We're not asking the Commission in our case to deregulate anything. As Mr. Barnett candidly admitted, the Commission has no jurisdiction over royalty cost. They do have jurisdiction over our entire right. And we brought forth a request for an increase in that regulated rate, and we asked them to consider all the relevant factors, and there were several put out in the testimony in the case below, at the hearing before the --

QUESTION: The Commission itself found that the -- I take it this is an accurate quote -- the Commission found that the impetus of the settlement is the market value of the royalties, and no consideration has been given to regulated rates. So the Commission equated this request with an intrastate unregulated market request.

MR. STEVENS: Your Honor, certainly we agree that the impetus of the litigation and the impetus of the settlement and the impetus of our application for relief was the litigation that was requesting the market value be based on intrastate or other prices. Simply because that is what caused this whole thing to get going doesn't mean that that's what the settlement was based on.

We view their holding, as set out on page 261 of the Joint Appendix, in the second sentence, the one I quoted earlier, as saying they have no authority. And that's certainly the way the Commission briefed it to the Fifth Circuit, and that's the way we briefed it.

I would suggest that since we're not asking the Commission to base any component of our rate on intrastate rates solely, even assuming that our prices were based in part on intrastate rates, we can't see how, as a matter of logic, the answer to the question of whether the Commission has authority should be any different.

Though we think what the Commission has done in this case is to do the same thing it did in Texaco, and that is to focus solely on one comparison, and that is a comparison of the settlement rate here with intrastate prices, and then to say, "We're sorry, Pennzoil, we're sympathetic to your plight, but Texaco tells us that we can't focus solely on this comparison and grant you a rate increase."

Pennzoil believes that our argument is consistent -- that our reading of Texaco, pardon me, is consistent with the purposes of the Act and with this Court's previous decisions and with the Commission's previous representations to the Court. And I'm talking specifically here about the Mobil case in review of the Southern Louisiana Area Rate case.

In the Commission's brief in that case, they specifically told the Court that the producers in a market value royalty bind could petition for individualized relief. We believe that that was the basis upon which the Commission was affirmed in setting area rates on that point.

QUESTION: Do you think the Columbia case is consistent with Texaco? I know that one is a pipeline and the other isn't, but --

MR. STEVENS: Yes, sir, I do.

QUESTION: Although there the request was based on an unregulated rate or unregulated cost.

MR. STEVENS: Yes, sir. There --

QUESTION: And a market price.

MR. STEVENS: Yes, sir. There, Your Honor, the item in question that was being priced was not an item over which the Commission had direct jurisdiction.

QUESTION: Right.

MR. STEVENS: And they did over the small producers in Texaco.

The Commission looked at the merits, as I understand it, in the Columbia case, of the prices --

QUESTION: Yes, but they didn't have any jurisdiction over the prices that were being charged in an unregulated market. Just like they don't have any jurisdiction over the royalty charges here.

MR. STEVENS: That's right. Your Honor, I view the Columbia case, the Texaco case and Pennzoil's position in this case as being entirely consistent. In the Columbia case, what the Commission did basically was to look at those costs that were being included, those purchase costs that were being included in the pipeline's flowthrough in their rates, and say, "We don't have jurisdiction over those, we can't automatically exclude them because, solely because they are equal to or based upon or tied to or related to in some way market value costs; but we do have the authority to review them on the merits and determine whether or not they meet the statutory Section 4 just and reasonable test."

And that's what we're here claiming the Commission has authority to do in our case.

I think it's also consistent with the El Paso case that you asked about earlier. In the El Paso case the Commission, in fact, granted the flowthrough in a jurisdictional rate of a royalty component that's virtually identical to the one that Pennzoil is asking for the flowthrough on. Virtually identical to it.

And they tried to distinguish that in their brief and in this argument on the basis that that's a pipeline and their cost of service is regulated individually. The face of the order in that opinion, at page 5, shows that they in fact had to waive the national rate regulations which were then applicable to El Paso's rates in order to grant them the relief.

It also shows that 25 percent of El Paso's production would continue to be priced at the applicable national rate for producers.

But that's not really the point. The point really is that Section 4 of the Natural Gas Act applies equally to producers and to pipelines. And if they have the authority to do it for pipelines, they have the authority to do it for producers. And we're not here arguing, and we didn't argue before the Fifth Circuit, that the Commission is compelled to regulate producers the same way it regulates pipelines.

If it can find reasonable reasons for distinguishing, for putting in one method of regulation for pipelines and one for producers, we have no quarrel with that, assuming they can support that on some reasoned basis.

Our only point is that it's the same statute, and the authority basically has to be the same. And I characterize the question of authority as more, quite frankly, than merely procedural. I believe it is more than procedural.

The Natural Gas Policy Act of 1978, of course we have not filed a brief on that, and I only have one brief comment on it; and that is, that under Section 502(c) of that statute it appears to expressly grant the Commission the authority to permit rate relief to any individual gas producer, notwithstanding that the end result of that rate would no longer be just and reasonable under Section 4 of the Natural Gas Act.

We are not arguing that as a basis for overturning the Commission's opinion, because it was not in effect at that time. But I thought it would be pertinent to at least call it to the Court's attention.

QUESTION: Do you think the Commission was required to grant you, your client, the relief you asked?

MR. STEVENS: No, sir, that is not our claim. We believe that on remand on the merits we will be able to show that our request is just and reasonable, that it was prudently incurred, and that it's in the best interest of the gas consumers of United Gas Pipe Line and of Pennzoil. And we will show in fact, and did show in fact, that more gas will be produced for the consumers; and that's why United has been supporting this case all the way along.

Thank you very much.

MR. CHIEF JUSTICE BURGER: Mr. Johnson.

ORAL ARGUMENT OF THOMAS G. JOHNSON, ESQ.,

ON BEHALF OF RESPONDENT SHELL OIL CO.

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

My name is Thomas G. Johnson, representing Shell Oil Company.

I would like to address first the question of the basis of the Commission's decision, which I believe is clear from the face of the opinion.

If the Court will refer to page 261 of the Appendix, the Commission said at that point, "We cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a State court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate."

I believe the Commission is saying, and reading *Texaco*, is that they do not have the authority to grant the relief requested by Shell and Pennzoil in this case.

QUESTION: But the sentence starts out, "As such", and I suppose that refers to the previous sentence?

MR. JOHNSON: Yes, Your Honor.

And the previous sentence, to make the record complete, says, "the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates." And that's the way the Commission reads Texaco.

If confirmation is needed, I believe it appears in the Court of Appeals opinion at page 6a of the Appendix to the Petition for Certiorari. And the Court of Appeals said, "the Commission concluded that it was 'not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates'."

QUESTION: Well, that's the very language that the Commission used in this same paragraph.

MR. JOHNSON: Yes, Your Honor, it is.

And I believe what this says is that the Commission did not reach the issue of whether the increased royalty costs would result in a ceiling rate being imposed on Shell and Pennzoil which is confiscatory.

It is our position that it is. The Administrative Law Judge disagreed with our position. The Commission did not reach it.

With reference to another issue which the Commission did not decide because of its position, is whether the increased royalty cost was prudently and reasonably incurred. This was specifically reserved by the Court of Appeals to the Commission on remand.

If the Commission's position is confirmed here, the Commission will never reach these issues because it contends that it has no authority to decide them.

I would now like to discuss the reference to Justice Blackmun's question about the Natural Gas Policy Act, and whether Congress has undermined the import of Texaco.

We believe that while the Natural Gas Policy Act fixes different categories, price categories for gas, it still makes a difference as to whether the gas was sold on the intra or interstate market. That as far as the rationale of Texaco is concerned, it is no longer material, because the ceiling prices set out prospectively in the Natural Gas Policy Act apply across the board, whether the sale is interstate or intrastate.

In fact, as a portion of that Act, Section 105, the Congress specifically approved intrastate contract prices for past periods as being the maximum lawful price permitted under the Act.

We therefore believe that the Commission and this Court's earlier concern about the unregulated market is no longer material under this Act.

As Mr. Stevens pointed out, this Commission has itself utilized intrastate prices along with other factors in determining producer rates in past cases. In the Area Rate proceedings, specifically the Other Southwest Area Rate case, the Commission did utilize intrastate prices in determining the producer rates. This use was attacked on appeal in the

Fifth Circuit and was specifically affirmed by the Fifth Circuit. This Court denied certiorari.

In the first National Rate proceeding on New Gas, Shell Oil Company v. FPC, at 520 Fed 2d, the issue was again raised in the National Rate case. The Commission relied on intrastate prices as one of the factors that it looked at in determining producer rates. It was again affirmed by the Circuit Court; this Court again denied certiorari.

Mr. Stevens has already referred to the pipeline case, which we believe are squarely in point here.

The Commission also, in dealing with the prices on emergency sales for natural gas and limited-term sales by producers, has referenced to comparable prices in the intrastate market in determining whether these sales are reasonable or unreasonable.

The Commission collects data on the intrastate market on Form 45, and quarterly publishes reports of that data, which it utilizes in producer rates.

We therefore do not believe the Commission acts consistently when it says that it cannot look to intrastate prices for any purpose.

We would also like to point out that we believe that this case is distinguishable from Texaco because the royalty provides only one of the cost components, which the Commission looks to in determining producer rates.

The price of the other cost components, steel pipe, labor, federal income taxes, is not subject to Commission regulation either. But, as the Court of Appeals pointed out, these prices are used as determinants in the Commission rate.

I would like to refer to a quotation which appears in the State of Louisiana brief from the Mississippi River Fuel case, decided by the D. C. Circuit, because it's very pertinent here:

"Expenses ... are facts. They are to be ascertained, not created, by the regulatory authorities. If properly incurred, they must be allowed, as part of the composition of the rates. Otherwise, the so-called allowance of a return on investment as being an amount over and above expenses, would be a farce."

QUESTION: Let me ask you, sir: Suppose the Commission hadn't talked about authority or what this statute required or authorized, but just said, "We've been setting area rates, and our rule is, and we think it's consistent with the statute, our rule is we'll never change an area rate just based on some single cost factor; or at least we will grant no exceptions from an area rate that we've set for an individual producer unless he shows that there's some confiscatory element in the picture. We might have authority to have a different rule, but this is our rule, we're just not going to grant any individual exceptions to an area rate.

If royalties go up or something like that, maybe we'll set a new area rate sometime, but until somebody is being put out of business, we're not granting any exception." Would that be inconsistent with the Act?

MR. JOHNSON: Mr. Justice White, I'd like to answer that question in three ways.

First of all, your question excepted the question of confiscatory rates.

QUESTION: Yes.

MR. JOHNSON: And we believe that is one of the issues in this case which the Commission refused to consider.

QUESTION: Yes.

MR. JOHNSON: Secondly, in the Permian case, part of the reason why this Court affirmed the area rate was the exception which the Commission said it would grant in special cases, like this case.

And, thirdly, in the Mobil case, the Commission expressly was faced with the situation here and asked by the producers in the Texas Gulf Coast Area Rate proceeding and the Southern Louisiana Area Rate proceeding, which became the Mobil case in this Court, to allow relief for this very problem, the market value royalty question on an area or a national basis. The Commission refused to do so. And in saying it refused to do so on a national or an area rate basis, it said that it took the position that producers could bring special relief cases like this case in order to get this question resolved.

The Fifth Circuit specifically affirmed the Commission on that basis, and the Fifth Circuit's language, if I could just quote it, is this: "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition the FPC for individualized relief."

That language from the Fifth Circuit was quoted in this Court's opinion in Mobil, with approval.

Now the producers are here before this Court, asking for the specific kind of individualized relief which this Court indicated in Mobil it would grant.

QUESTION: My question was: Would it be contrary to the Act for the Commission to have the rule that I posited? And you've said up to now it doesn't seem to have had that rule; that's all you've said so far.

But, is it your position that it would be contrary to the Act if the Commission said, "We're just not going to grant any exceptions unless there's some claim of confiscatory rates"?

MR. JOHNSON: Your Honor, again I would refer to the Permian case, and, as I read Permian, that was one of the bases that this Court utilized in affirming --

QUESTION: So your answer is that it would be contrary to the Act?

MR. JOHNSON: I think it would be contrary to the Act if the Commission, in so doing, imposed a confiscatory rate. The purpose of the exception, the specific exception for an individual case, is to allow the Commission to consider this question. And I believe other cases in this Court have indicated that the Commission cannot impose a confiscatory rate. Even in an area rate case.

QUESTION: Well, would you be satisfied in this case if the Commission said, "We'll grant you relief when and if you show that it's confiscatory"?

MR. JOHNSON: Your Honor, what we're asking for in this case --

QUESTION: That isn't all you're asking, is it? That isn't all you're asking?

MR. JOHNSON: Well, --

QUESTION: You're asking them to -- in any event, that they must, or at least they've got the authority to re-determine the just and reasonableness of a rate, based on new royalty costs, in any case, whether it's confiscatory or not. Isn't that true?

MR. JOHNSON: Your Honor, I think -- if I could re-state our position -- I think what we're asking is this: Since the Commission expressly refused to consider this problem in the area and national cases, and told this Court that this was the kind of case they would consider, that we believe we're entitled to that kind of consideration.

Now, the Commission can hold against us on the merits, and if this Court affirms the Court of Appeals, the case will go back before the Commission on remand and it will consider the merits of the confiscation question.

On the other hand, if the Commission is affirmed, the question will never be considered, because the Commission will have been found without authority to consider it.

QUESTION: Well, you would be satisfied, then, if the only thing that were left open on remand is whether or not the result would be confiscation if your request is not --

MR. JOHNSON: Your Honor, I think the answer is I would not be satisfied.

QUESTION: You want a little more than that, I would think.

MR. JOHNSON: Yes, Your Honor. I think what we want is a fair trial on the merits, and that's what we're asking.

QUESTION: And the merits are more than just the question of confiscation?

MR. JOHNSON: Yes. I think the merits also go to the question of whether the royalty cost is reasonable and prudently incurred.

QUESTION: Right. So you --

MR. JOHNSON: And this is the historic test which the Commission utilized in determining whether costs are granted.

QUESTION: So it's not just the confiscation item that you want?

MR. JOHNSON: That is correct. And as I understood Your Honor's question when addressed to me, that was what the Commission would be required to do under the law. But we believe they should also consider whether or not these costs are prudently incurred.

If I could turn now to another point. The end-result test is the test which this Court has historically imposed on Commission decisions. I would like to consider, for this Court's attention, just for a moment the end result on the parties of the Commission's opinion.

When Shell got in this bind, as described by the Court of Appeals, by executing its lease in 1934, before the Natural Gas Act was even passed, the second lease in 1952 was executed two years before this Court's Phillips decision, and the Commission was not regulating producers.

It wasn't until 1965, in the Permian case, when the Commission decided that it would reject individual company's cost of service as a method of regulation of producers, and would also reject market value studies, economic studies of market value, and would rely instead on a composite industry-wide cost of service -- which, incidentally, included a royalty cost of 12.5 percent.

It was not until the Huber and Vela cases were decided in 1966 and 1968 that the producers suspected that the lessors would be entitled to ascribe a higher price to their royalty percentage and the lessee was permitted to charge under regulation.

It was not until the Mobil case, decided by the D. C. Circuit in 1971, that the Commission was held not to have the authority to impose the same ceiling on the lessor. When the producers found out they were in this bind, they asked the Commission for relief in the Texas Gulf Coast and Southern Louisiana area rate cases, the Commission was assured that if we came back in an individual relief case, they would grant relief there.

This is that case, and the Commission now contends they do not have jurisdiction to grant this relief.

If I could turn for just a moment to the abandonment question, here again we believe the Commission has not fully considered the case on the merits. The only point considered by the Commission was whether, if Shell's leases were cancelled and the lessor became the owner of all of the gas in the leases, it would be required to continue to sell that gas in interstate commerce.

Of course this Court's Southland opinion holds that the lessor would be so required. But I believe the Commission's duty under the public convenience and necessity test of Section 7 goes further. We believe that the Commission must consider the end result on all the parties.

From the standpoint of the lessee, the end result of denial of abandonment is the confiscation of the lessee's leases.

From the standpoint of the lessor, and the standpoint of the consumer, the consumer's price will go up; and I will leave that discussion to my brief.

Thank you, Your Honor.

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

REBUTTAL ARGUMENT OF STEPHEN R. BARNETT, ESQ.,

ON BEHALF OF THE PETITIONER

MR. BARNETT: Just a couple of brief points, Mr. Chief Justice.

First of all, with respect to the Mobil case, which my brothers rely on, the Court said there that Mobil's argument is hypothetical at this stage, and that, in any event, an effective producer is entitled to seek individualized relief. The Court went on to quote the D. C. Circuit, which said: "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief. Permian contemplated it." End of this Court's quote.

Well, we would say, first of all, that producers here were entitled to seek individualized relief. They did seek it, and the Commission decided that it would be inconsistent with the Act to grant it.

Further, we would deny that the producers here have been put in a bind in the terms of the Mobil decision. The Court went on to say, "Permian contemplated it." Well, what did Permian contemplate?

If one looks at the relevant language in the Permian decision, 390 U.S. at 770, the Court there said, "The Commission declared that a producer should be permitted appropriate relief if it establishes that its out-of-pocket expenses in connection with the operation of a particular well exceed its revenue from the well under the applicable area price. The Commission acknowledged that there might be other circumstances in which relief would be given, but declined to enumerate them."

QUESTION: In your view, the language of Mobil, I think it was, of being in a bind does not occur until the rates are confiscatory?

MR. BARNETT: Yes, we would interpret it that way, and we would rely on the reference to Permian, which did precisely interpret the relief provision that way.

To respond to the point about whether the Commission here did in fact rely on the fact that these proposed incremental royalties were based on the intrastate rate, we submit that that's clear. At page 261 of the Appendix, the Commission said: "In the instant proceeding, the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates.

On rehearing, at page 290, the Commission said -- I'm sorry, 291 to 292 -- "it is plain that the royalty is to be based on 78 cents, which is the settlement's reflection of market prices, that are above the area ceiling prices."

The Court of Appeals, Petition Appendix 3a, stated that, "in Louisiana state court, a lessor asserted a royalty claim based on intrastate prices for natural gas, which greatly exceed the ceiling rates established by the FPC for interstate sales."

Similar statements can be found in the Appendix, in the initial decision at page --

QUESTION: Mr. Barnett, what was the connection between 78 cents and the intrastate market price?

MR. BARNETT: The record does not disclose what the connection was, Mr. Justice --

QUESTION: But it was 150 percent of the regulated rate?

MR. BARNETT: The alternative to the 78 cents -- oh, yes, the --

QUESTION: The 78 cents was. The other rate was

52 cents.

MR. BARNETT: The 78 cents was in fact 150 percent of the regulated rate for small producers.

QUESTION: Isn't that pretty strong evidence that it's based on the regulated price?

MR. BARNETT: Well, --

QUESTION: And it had no relationship, as I understand you, to the unregulated price.

MR. BARNETT: Well, it may well have, if the unregulated price range was about 140 or 150, the 78 cents may well have been thought to be about half of it.

But the short answer is --

QUESTION: But there's no evidence that they did that, and there is some testimony, not in the Appendix, that it was based on the regulated rate.

MR. BARNETT: Well, but --

QUESTION: Isn't that right?

MR. BARNETT: Well, so my colleague says, but we would submit that --

QUESTION: Do you disagree with that?

MR. BARNETT: Well, I haven't seen it; I certainly wouldn't challenge his statement.

QUESTION: Well, is there any evidence in the record that it was based on the intrastate market?

MR. BARNETT: Well, there's lots -- yes, for example, at page 55, testimony of Mr. Smith for United Gas Pipe Line Company, who says the 78-cent price is very -- "which I feel is very reasonable in light of today's market prices."

Page 56, "We are prepared to show ... what the latest arm's-length intrastate prices are in this area of South Louisiana, and it will show when I read these numbers the very reasonable price level of 78 cents for the settlement."

But apart from all that --

QUESTION: That's all to show that it was prudently incurred, I suppose?

MR. BARNETT: Yes. But apart from all that, we would say the computation, the mode of computation is irrelevant. It's clear that the suit was for market value based on the intrastate price, the settlement is to get rid of the suit. The means of computation has no legal impact, we would say.

Thank you very much.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen. The case is submitted.

[Whereupon, at 3:04 p.m., the case in the above-entitled matter was submitted.]

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