10-1978

Federal Energy Regulatory Commission v. Pennzoil Producing Co.

Lewis F. Powell Jr.

I have remained "Out"
in Mobil Oil v. Lightcap 76-1694
because of pendency of "identical"
suits by others including Exxon.

~~the SG~~

This case may be a Hold
for Southland — in which Exxon
is a party.

PRELIMINARY MEMORANDUM

January 6, 1978 Converence
List 3, Sheet 2

The other parties are Shell Oil Co.
and United Gas Pipe Line Co.
ga

No. 77-648

FEDERAL ENERGY REGULATORY COMM'N

v.

PENNZOIL PRODUCING CO.

Cert to CA 5
(Clark, Roney &
Tjoflat)

Federal/Civil Timely

1. SUMMARY: Many leases of land for the development of gas link royalty payments to the "market value" or "market price" of the gas produced; as the market price of intrastate gas and the regulated price of interstate gas have grown more and more divergent, the question has arisen whether "market value" refers to the intrastate or interstate price of gas. In 1971, the CADC removed one possible federal

Hold for FPC v. Southland Royalty Co., No. 76-1587; then deny.
ga

barrier to interpreting "market price" as intrastate price when it ruled that the FPC does not have jurisdiction over the royalty payments made to lessors. Mobil Oil Corp. v. FPC, 463 F.2d 256 (1971), cert. denied, 406 U.S. 976 (1972). And recently some state courts have interpreted "market price" as intrastate price. See, e.g., Mobil Oil Corp. v. Lightcap (Kan.), No. 76-1694, cert. denied, October 3, 1977, petn for rehearing pending. The issue in this case is whether the Federal Energy Regulatory Commission (FERC) can permit gas producers hit by the higher royalty payments to either (1) increase their interstate price by the amount of the increase in royalty payments, or (2) "abandon" the "royalty portion" of the gas produced so that the royalty owner can dispose of it himself, unburdened by the restrictive interstate price. The FERC held that it did not have the authority to permit such actions; the CA 5 reversed and remanded; and the FERC now petitions for cert.

2. FACTS: In 1974, resps' lessor notified resps that its royalties, linked to "marked price," should be computed on the basis of intrastate prices; resps sought declaratory relief in state court and the lessor counterclaimed for back royalty payments. In June of 1975 the parties tentatively settled; according to their agreement, royalties would in the future be based on the higher of the following prices: (1) 78 cents for Mcf for 1975 with annual increases of 1.5 cents per Mcf; or (2) 150% of the highest area or national rate permitted by the FERC; in the alternative, resps could deliver to the lessor his "royalty share"

of the gas; the first alternative, however, was dependent on FERC approval of a corresponding price increase for the produced gas and the second alternative was contingent on FERC approval of the abandonment

The FERC denied resps both approvals. With respect to the requested price increase, the FERC concluded that it did not have the authority under the Natural Gas Act to approve rate increases that were based on royalty payments linked to the free market price of gas:

> "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. As such, 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. On this point, we note the Supreme Court's warning in FPC v. Texaco, [417 U.S. 380 (1974)] that the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges.' [Atlantic Refining Co. v. Public Service Comm'n, 360 U.S. 378, 388 (1961)]."

Nor did the Commission believe that it could permit abandonment of the royalty gas since it had not been demonstrated that "the present or future public convenience or necessity permit such abandonment." 1/

1/ Under section 7(b) of the Natural Gas Act, the FERC can permit abandonment only where it finds either (i) that the available supply of gas has been "depleted to the extent that continuation of service is unwarranted," or (ii) that "the present or future public convenience and necessity permit such abandonment."

Resps had argued that this standard was met: if resps were not permitted to abandon the royalty gas, the lessor might terminate their lease when, as probable, they are unable to pay the higher and back royalty payments; this would result in the loss of all of the gas from the interstate market. The FERC replied that under its decision in El Paso Natural Gas Co., FPC Opinion No. 737 (July 11, 1975), rev'd, Southland Royalty Co. v. FPC, 543 F.2d 1134 (5th Cir. 1976), presently under review here, even if the leases were terminated, the lessor would not be able to withdraw the gas from the interstate market. Thus, the public convenience did not require abandoning the royalty gas.

The CA 5 disagreed outright with the FERC's conclusion that it did not have jurisdiction to grant the requested rate increase. FPC v. Texaco, Inc. was inapposite. In that case, the Court held that it could not abandon outright the regulation of small gas producers by effectively allowing them to charge the market price. Here, resps are not asking to charge the marked price but are merely asking to increase their prices to take into account increased royalty payments. The FERC has taken, and this Court has approved, a cost-based approach to gas rate regulation. Permian Basin Area Rate Cases, 390 U.S. 747 (1968). And clearly one element of the producer's cost is his royalty expense. See Shell Oil Co. v. FPC, 520 F.2d 1061, 1068 (5th Cir. 1975), cert. denied, 426 U.S. 941 (1976). This Court has clearly contemplated that the FERC will consider individualized rate increases when a producer is confronted by increased royalty payments. Mobil

Oil Corp. v. FPC, 417 U.S. 283, 328 (1974) ("If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief"). The fact that the royalty payment increases reflect increases in the market price of intrastate gas is irrelevant for purposes of FERC authority to grant the rate increases. It is the producer and not the landowner who is regulated by the FERC. As to this first alternative, therefore, the CA 5 remanded for a consideration on the merits of resps' request.

As for the abandonment request, the CA 5 noted that the FERC was acting on the mistaken belief that their opinion in El Paso Natural Gas Co. was valid. If the FERC had known that their opinion would be reversed by the CA 5, it might have reached a different conclusion as to whether the public convenience called for the abandonment of the royalty gas. The CA 5 thus remanded for further consideration of the public convenience in light of its recent decision in Southland Royalty Co. v. FPC.[2/]

3. CONTENTIONS: A. Proposed Price Increase: The SG, petitioning for the FERC, contends that this Court's decision in Texaco not only prevents the FERC from setting interstate produced-gas prices at the market level but also prevents the FERC from basing these interstate

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2/ In its original opinion, the CA 5 had language that could have been interpreted to conclude that Southland Royalty Co. applies not only to the natural termination of a fixed-term lease but also to a state court termination of a lease not limited by a fixed-term. When this was pointed out on petition for rehearing, however, the panel deleted the suspect sentences.

prices in part on any cost that is linked to the intrastate price. "Contrary to the CA's view, royalty costs that are based on intrastate market price of gas are different from other costs (e.g., drilling costs), because allowing a producer to pass such royalty costs through to interstate customers results in a price for interstate gas that is based in part on the unregulated price of gas, contrary to the principles established in Texaco." Mobil Oil Corp. v. FPC, decided the same day, is not to the contrary. There, the Court simply said that, where a producer is faced by increased royalty costs, he can seek individualized relief. "The Court did not discuss or purport to determine the entitlement to relief under all circumstances, or to decide in particular whether a producer would be entitled to a rate increase to reflect royalty costs based on the unregulated market."

Resps reiterate the arguments made by the CA 5. They also emphasize that the CA 5 did not order the FERC to permit the requested price increases. Instead, the CA 5 simply ruled that the FERC could not reject the proposed price increases solely because they were based on a cost that was linked to the intrastate price of gas. The CA 5 thus remanded for further consideration of the reasonablenss of the requested increase, which the FERC could still reject.

B. Proposed Royalty Gas Abandonment: Here, the SG seems to misunderstand the thrust of the CA 5's decision and contends that the FERC's finding that the public convenience would not be served by the abandonment fully supports its decision not to allow the abandonment.

Resps correctly respond that the CA 5 merely noted that this finding was based on an incorrect perception of the law and remanded for further consideration by the FERC; on remand, the FERC is free to reach the identical conclusion that it did before.

The SG also suggests in a footnote that the Court hold this petn until a decision is entered in Southland Realty Co.

C. General Comments: At the end of his petition, the SG admits that the decision of the FERC leaves the resps in a serious bind -- their royalty costs are increasing and yet their sales price is fixed -- and suggests that this might have influenced the result of the CA 5. The SG suggests that there are two other means by which this Court could relieve resps of this profit squeeze, both of which would be more compatible with the Natural Gas Act. First, the Court could reconsider the CADC's decision in Mobil Oil Corp. v. FPC, 463 F.2d 256 (1971), cert. denied, 406 U.S. 976 (1972), and hold that "despite the nonjurisdictional status of landowner/lessors, royalty payments are nevertheless subject to regulation in the sense that producer/lessees need not pay royalties which exceed the amounts permitted by the Commission to be passed on to the jurisdictional pipelines." Alternatively, this Court could grant cert in Mobil Oil Corp. v. Lightcap and apparently hold, as a matter of federal preemption law, that a state court cannot interpret "market price" in a gas lease as meaning the intrastate price.

Resps Pennzoil Producing Co. and United Gas Pipe Line Co. respond that this case does not raise either of these two possibilities and that they are thus not before the Court. Resp Shell Oil Co. applauds the SG's suggestions and notes that it would support both results.

4. DISCUSSION: Taking the abandonment issue first, this portion of the CA 5's decision does not merit cert. As resps note, the court merely remanded to the FERC for further consideration in light of the court's reversal in Southland Royalty Co. While it would presently appear that this Court will affirm the CA 5 in Southland Royalty Co., this petn should probably be held for the Court's disposition in that case.

Turning to the price increase question, the FERC would seem to be confronted by a serious problem. If it does not allow the price increases, and it obviously does not believe that they are in the "public's interest," resps and other gas producers will be placed in a severe profit squeeze that might literally be termed "confiscatory." According to Shell, the record shows that if the lessor prevails in the state court action and the FERC denies all special relief, Shell will suffer a net loss of 3.5 cents for each Mcf of gas that it sells from one of the two leases in question here. On the other hand, if the FERC allows the resps to pass through their royalty increases, resps will have no incentive to defend in state court against the increases (possibly evidenced by the settlement agreement here).[3/]

3/ I would assume that if, upon remand, the FERC should determine that there is no merit to the state court claim or similarly that the settlement agreement is conspiratorial, it could deny the requested price increase on the ground that it is not reasonable.

While recognizing the difficulties faced by the FERC, however, the CA 5 would seem to be correct in its interpretation of both the Natural Gas Act and past decisions of this Court. The FERC would seem to have authority to grant the requested increases. And the question before the FERC would seem to be whether the increase is "reasonable," not merely whether the request stems from a cost increase that is linked to the free market price of gas. The SG's arguments to the contrary seem strained.

Similarly, the SG's alternative suggestions for solving the producers' profit squeeze are legally doubtful. The CADC's decision in Mobil Oil Corp., is convincing, no doubt evidenced by this Court's denial of cert. And the question of whether "market price" = intrastate price for purposes of royalty payments would seem to be entirely a question of state law, as discussed in the Preliminary Memorandum for Mobil Oil Corp. v. Lightcap, No. 76-1694.

Federal regulation of interstate gas without parallel regulation of intrastate gas has produced innumerable problems. This case evidences a new one, compounded by the absence of FERC jurisdiction over royalties. The problem, however, is not in the courts' interpretation of the Natural Gas Act but in the structure of the Natural Gas Act itself. The problem, while real, would thus seem to be one for Congress who, of course, is presently reevaluating its system of interstate gas regulations. In conclusion, while the importance of this case might call for cert, I would be inclined to deny on the strength of the CA 5's position.

There are responses.

12/14/77 Thompson Op in petn.
CMS

The United States is trying its darndest to prevent the price of gas from rising. This petition should be held at least until FPC v. Southland Royalty Co., cert. granted, No. 76-1587, is decided, because that case will affect the second branch of the CA's holding here (on abandonment).

Second "Branch" of case - a Hold.

As to the first branch, which presents the question whether the FERC has the power to grant rate increases because of the increase in the price of intrastate gas, I tend to agree that CA5 was correct. The SG's position would, indeed, put the producers in a squeeze between the uncontrolled price of intrastate gas and the controlled price at which they can sell interstate gas. The other side of this squeeze is presented in Mobil Oil Co. v. Lightcap, No. 76-1694, pet. for rehearing pending, where petrs contend that the price of intrastate gas (determined under state law) cannot exceed the price of interstate gas determined by the FPC. The SG supports the petition for rehearing in that case, and contends that it is necessary to tie the price of intrastate gas to that of interstate gas in order to keep prices to consumers down. The difference between that case and this one is that there, the SG would place the loss on the owners of intrastate gas, while here, he ~~x~~ would place it on the companies that buy intrastate gas and ship it interstate.

First - a Deny

I would deny in both that case and this one, because the problem is one created by Congress and one that Congress (theoretically) is working on solving. Meanwhile, CA5's result is one with which everyone can live. The SG's solutions may not be.

JA

Court ....
Argued ...., 19...
Submitted ...., 19...

Voted on................., 19...
Assigned ...., 19...
Announced ...., 19...

No. 77-648

FEDERAL ENERGY REGULATORY COMM'N.

vs.

PENNZOIL PRODUCING CO.

Out

	HOLD FOR	CERT.		JURISDICTIONAL STATEMENT				MERITS		MOTION		ABSENT	NOT VOTING
		G	D	N	POST	DIS	AFF	REV	AFF	G	D		
Burger, Ch. J.													
Brennan, J.													
Stewart, J.													
White, J.													
Marshall, J.													
Blackmun, J.													
Powell, J.													
Rehnquist, J.													
Stevens, J.													

Supreme Court of the United States
Washington, D. C. 20543

CHAMBERS OF
JUSTICE BYRON R. WHITE

June 6, 1978

77-648
OUT

MEMORANDUM TO THE CONFERENCE

Re: Cases heretofore held for Nos. 76-1114, 76-1133 & 76-1587 - California, et al. v. Southland Royalty Co.

Two interrelated cases have been held for our decision in Southland Royalty Co. Both involve leases of gas sold in interstate commerce in which the royalty payments are linked to the "market price" or "market value" of the gas.

In No. 76-1694, Mobil Oil Corp. v. Lightcap, et al., the lessors brought suit in state court to recover royalties based on the intrastate rate rather than on the interstate rate at which the gas was being sold under an FPC (FERC) certificate. The Kansas Supreme Court held that it had jurisdiction to construe the royalty clause of the lease and that "market value" referred to the intrastate rate. The lessee-producer sought certiorari in this Court, arguing that the FPC has jurisdiction to regulate a royalty clause as a "contract affecting such rate" within the meaning of 15 U.S.C. § 717d(a) of the Natural Gas Act, that the field was therefore preempted by federal law, and that the interpretation of the royalty clause adopted by the Kansas court should be rejected as inconsistent with the purposes of the Act. I

Out

You are "out" of both of the holds. Bob

granted a stay of the state court decision pending disposition for certiorari by this Court. Certiorari was denied on October 3, 1977. The FERC belatedly filed a brief amicus curiae supporting petitioner's position and urging that the petition for rehearing be considered together with the FERC petition in No. 77-648, FERC v. Pennzoil Producing Company.

In FERC v. Pennzoil Producing Company, supra, the lessor and lessees settled a state court action to interpret a royalty clause based on "market price." They agreed that the lessees could either pay a royalty based on a "market price" substantially in excess of the current interstate rate at which the lessees were actually selling the gas or the lessees could deliver to the lessor his royalty share in the form of the gas itself. The first alternative was to be contingent on FERC approval of a corresponding increase in the price of the lessee's gas and the second alternative was contingent on FERC approval of the partial abandonment. Out

The FERC held that, under FPC v. Texaco, 417 U.S. 380 (1974), the Commission was not free to allow royalty costs based on intrastate market values to be passed on to the pipelines as "just and reasonable rates." The Commission also held that the "present or future public convenience" would not be served by granting an abandonment authorization that would permit diversion of the gas to the intrastate market. Even if the leases were terminated as a result of the state court litigation, under the FERC decision in Southland, the lessors would be obligated to continue to serve the interstate market.

The CA 5 reversed and remanded. It held that because royalties based on the intrastate market price represented costs rather than profits they could be passed on to consumers through a rate increase. While the Commission has authority to consider the reasonableness of cost components, royalty costs based on the prevailing price in an uncontrolled market were no more unreasonable than other costs based on free market prices. The FERC should reconsider its denial of abandonment because it relied on its decision in Southland Royalty Co., which had been reversed by the CA 5.

In its petition for certiorari, the FERC argues that the decision below will lead to an interstate rate based on intrastate prices, in contravention of the scheme of the Act and the decisions of this Court. Abandonment is also not justified simply to serve the financial interests or royalty owners or producers. In order to protect producers from a cost-price squeeze, the Commission should be permitted to assert jurisdiction over the amount of royalty payments by producers, though not necessarily over the royalty owners. Alternatively, the Court should rule in Mobil Oil that the interpretation of a royalty agreement implicates a question of federal law insofar as it refers to "market price."

Discussion: In light of Southland, the CA 5 discussion of abandonment requires further consideration. Southland does not decide, however, the pricing question raised in Pennzoil or the jurisdictional questions raised in Mobil Oil. Royalty costs are not like other costs based on unregulated market prices because royalty costs are based on the price of gas itself. Whether the disparity between intrastate and interstate prices can be passed on to consumers in the form of increased royalty costs seems to me a difficult and important question. Accordingly, I will vote to GRANT in Pennzoil.

If royalty costs based on intrastate rates may not be included in the interstate price, producers subject to "market price" leases may need some form of relief. In order to protect their interests and assure the widest possible range of alternatives for consideration by the Court, I will also vote to GRANT in Mobil Oil Corp.

BRW

Court .... Voted on.................., 19...

Argued ...., 19... Assigned ...., 19... No. 77-648

Submitted ...., 19... Announced ...., 19...

FED. ENERGY REGULATORY COMM'N.

vs.

PENNZOIL PRODUCING CO.

Heretofore held for decision in Nos. 76-1114, 76-1133 & 76-1587 - California, et al. v. Southland Royalty Co. You are OUT.

(granted)

Out

	HOLD FOR	CERT. G	CERT. D	JURISDICTIONAL STATEMENT N	POST	DIS	AFF	MERITS REV	MERITS AFF	MOTION G	MOTION D	ABSENT	NOT VOTING
Burger, Ch. J.		✓											
Brennan, J.		✓											
Stewart, J.						Out							
White, J.		✓											
Marshall, J.		✓											
Blackmun, J.		✓											
Powell, J.						Out							
Rehnquist, J.		✓											
Stevens, J.		✓											

January 3, 1979

No. 77-648 Federal Energy v. Pennzoil

Dear Byron:

Please show at the end of the next draft of your memorandum that I took no part in the consideration or decision of this case.

Sincerely,

Mr. Justice White

lfp/ss

cc: The Conference

CHAMBERS OF
JUSTICE POTTER STEWART

January 3, 1979

Re: No. 77-648, FERC v. Pennzoil Producing Co.

Dear Byron,

I did not participate in the consideration or decision of this case, and should appreciate that fact being noted at the foot of the Court's opinion.

Sincerely yours,

P.S.

Mr. Justice White

Copies to the Conference

give out also

Supreme Court of the United States
Washington, D. C. 20543

CHAMBERS OF
JUSTICE POTTER STEWART

January 3, 1979

Re: No. 77-648, FERC v. Pennzoil Producing Co.

Dear Byron,

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Sincerely yours,

P.S.

Mr. Justice White

Copies to the Conference

give out also

Supreme Court of the United States
Washington, D. C. 20543

CHAMBERS OF
JUSTICE WM. J. BRENNAN, JR.

January 3, 1979

RE: No. 77-648 Federal Energy Regulatory Commission
v. Pennzoil Producing Company, et al.

Dear Byron:

I agree fully with your Memorandum in the above and will be happy to join it as the opinion for the Court.

Sincerely,

Bill

Mr. Justice White

cc: The Conference

Supreme Court of the United States
Washington, D. C. 20543

CHAMBERS OF
THE CHIEF JUSTICE

January 11, 1979

No. 77-648 - FERC v. Pennzoil

Dear Byron:

I join.

Regards,

WEB

Mr. Justice White

Copies to the Conference

THE C. J.	W. J. B.	P. S.	B. R. W.	T. M.	H. A. B.	L. F. P.	W. H. R.	J. P. S.
			11/12/78					
join BRW 1/11/79	join BRW 1/3/79	out 1/3/79	1st draft 1/3/79	join BRW 1/3/79	join BRW 1/4/79	out letter 1/3/79	join BRW 1/8/79	join BRW 1/4/79
			2nd draft 1/5/79					

77-648 Fed Energy v. Pennzoil