

Spring 1981

## Administrative Rule Making and the Standard Oil Decision: The Impact of Cost Recovery Sequence before Decontrol

Bruce J. Stavitsky

Follow this and additional works at: <https://digitalcommons.law.utulsa.edu/tlr>



Part of the [Law Commons](#)

---

### Recommended Citation

Bruce J. Stavitsky, *Administrative Rule Making and the Standard Oil Decision: The Impact of Cost Recovery Sequence before Decontrol*, 16 Tulsa L. J. 453 (1981).

Available at: <https://digitalcommons.law.utulsa.edu/tlr/vol16/iss3/3>

This Legal Scholarship Symposia Articles is brought to you for free and open access by TU Law Digital Commons. It has been accepted for inclusion in Tulsa Law Review by an authorized editor of TU Law Digital Commons. For more information, please contact [megan-donald@utulsa.edu](mailto:megan-donald@utulsa.edu).

# ADMINISTRATIVE RULE MAKING AND THE *STANDARD OIL* DECISION: THE IMPACT OF COST RECOVERY SEQUENCE BEFORE DECONTROL

Bruce J. Stavitsky\*

## I. INTRODUCTION

In 1975, a number of oil refiners<sup>1</sup> in response to amended regulations<sup>2</sup> issued by the Federal Energy Administration, adopted a non-product costs first sequence of recovery<sup>3</sup> which enabled them to recover their non-product or non-oil costs<sup>4</sup> before they recovered their product

---

\* Energy Consultant, Coopers & Lybrand, Washington, D.C.; B.A., Fairleigh Dickinson University; J.D., Temple University School of Law.

1. 10 C.F.R. § 212.31 (1980).

"Refiner" means a firm (other than a reseller or retailer) or that part of such a firm which refines covered products or blends and substantially changes covered products, or refines liquid hydrocarbons from oil and gas field gases, or recovers liquefied petroleum gases incident to petroleum refining and sells those products to resellers, retailers, reseller-retailers or ultimate consumers. "Refiner" includes any owner of covered products which contracts to have those covered products refined and then sells the refined covered products to resellers, retailers, reseller-retailers or ultimate consumers.

*Id.*

2. 39 Fed. Reg. 42,368 (1974) (codified in 10 C.F.R. § 212.83(d) (1980)).

3. Pursuant to the amendments adopted, effective January 1, 1975, refiners used three methods of recovering increased costs: The NPCI first method, where non-product cost increases were first recovered; the NPCI last method, where product cost increases were recovered first; and the proportional method, where increased costs were recovered pro rata. *Standard Oil Co. v. Department of Energy*, 596 F.2d 1029, 1037 (Temp. Emer. Ct. App. 1978).

4. 10 C.F.R. § 212.83 (1980). The categories of non-product costs which a refiner could pass through as price increases include: (1) refinery fuel cost increase, calculated according to the weighted average cost of refinery fuel per unit of energy (dollars per million British Thermal Units (BTU)); (2) labor cost increase, referring to the "total dollar amount of direct and indirect remuneration or inducement for personal services which are reasonably subject to valuation for those personnel employed at the refinery . . . operations, including that portion of [contract costs] between a refiner and an outside entity attributable to personnel other than employees that perform such services"; (3) additive cost increase or "the total dollar amount of costs incurred for materials and compounds . . . which are added to, use [*sic*] for, or blended with crude oil or covered products during or in conjunction with the refining process to produce products other than gasoline"; (4) utility cost increase; (5) interest cost increase; (6) container cost increase or "the dollar amount of costs incurred for containers . . . used by the refiner for storing or packaging [price-controlled] products"; (7) federal, state, and local tax cost increase including the dollar

or raw material cost increases.<sup>5</sup> The recovery of non-product costs and product costs by these refiners was a justification for price increases in petroleum products which would be passed through to and absorbed by the consumer since prices for refined petroleum products had been frozen at a May 15, 1973 base price level.<sup>6</sup>

It was important for these refiners to recover their non-product costs first because the increased product costs could be banked<sup>7</sup> for recoupment at a later time while non-product cost increases were banned from banking, thus making the recovery of product cost increases less immediate than the recovery of non-product costs.

At issue in *Standard Oil Co. v. Department of Energy*<sup>8</sup> was the Federal Energy Administration's<sup>9</sup> (FEA) disallowance of the non-product

amount of federal, state, and local property, excise, franchise and other similar taxes but not including income taxes; (8) maintenance cost increase; and (9) depreciation cost increase, referring to the cost attributable to the depreciation of refinery and storage capacity and equipment installed, provided that such costs are computed according to the generally accepted accounting practices historically and consistently applied by the refiner. *Id.* § 212.83(c)(2)(iii)(E)(1)-(9).

5. The cost of product or raw material, for purposes of crude oil, is the purchase price plus the cost of transportation. Increased product costs for petroleum products other than crude oil is the purchase price including transportation costs.

"Increased product costs" means the "increased costs of crude oil" plus the "increased costs of products purchased" and is the sum of (1) the difference between the costs of crude oil during the month of measurement and the cost of crude oil during the month of May 1973 plus (2) the difference between the cost of products purchased during the month of measurement and the costs of products purchased during the month of May 1973. If a particular petroleum product was neither purchased nor landed during the month of May 1973, the cost of that petroleum product in May 1973 shall be imputed to be the lowest price at or above which at least 10 percent of that product was priced by the refiner in transactions during the month of May 1973.

*Id.* § 212.82.

6. The regulations establish the maximum allowable price for regulated petroleum products as "the weighted average price at which the covered product was lawfully priced in transactions with the class of purchaser concerned on May 15, 1973, plus increased product costs and increased non-product costs incurred between the month of [the transaction] and the month of May 1973." *Id.* § 212.83(a)(2) (1974).

The May 15, 1973 base price structure was an important component of the Phase IV regulations which established rules governing the pricing of petroleum products. 596 F.2d at 1035.

7. Increased costs incurred in a month of measurement and not recovered in the current month may be carried forward or "banked" for recovery in subsequent months. 10 C.F.R. § 212.83(e)(4) (1980). The ban on banking non-product cost increases was issued November 29, 1974, and published December 5, 1974. The FEA failed to publish the regulation prior to its effective date pursuant to the procedural requirements of the Federal Energy Administration Act, 15 U.S.C. § 766(i)(1)(B) (1976), thereby rendering the regulation invalid. 596 F.2d at 1037.

8. 596 F.2d 1029 (Temp. Emer. Ct. App. 1978).

9. The Federal Energy Administration was the agency responsible for regulating the petroleum industry before its incorporation into the Department of Energy on October 1, 1977. On May 7, 1974, the Federal Energy Administration Act (FEAA) was signed into law. Pub. L. No. 93-275, 88 Stat. 96 (codified at 15 U.S.C. §§ 761-786 (1976 & Supp. III 1979)). In June, 1974, the FEA was delegated the authority to implement the allocation and price stabilization provisions of the Emergency Petroleum Allocation Act (EPAA), Pub. L. No. 93-159, 87 Stat. 627 (codified at 15 U.S.C. §§ 751-760h (1976)).

costs first sequence of recovery. In February 1976, without notice of the rule making and without providing an opportunity to comment, the FEA ruled<sup>10</sup> that the refiners were required to recover all product costs before any non-product cost increases could be passed through. The FEA made this ruling both prospective and retroactive to 1975, and maintained that the refiners' misinterpretation of the non-product cost rules enabled them to net about one billion dollars<sup>11</sup> from the recovery of non-product cost increases. The FEA later rescinded the regulation but wanted to enforce its substance for the year 1975. The refiners asserted that the effect of this ruling would have been a disincentive to building refined petroleum product inventories which could have led to product shortages in periods of peak demands.<sup>12</sup> The refiners contended that no express sequence of recovery rule had been adopted prior to the February 1, 1976 rule making and that the February rule was the first explicit statement of a product costs increase first interpretation.

The issue to be examined in this article<sup>13</sup> concerns whether the February 1976 regulation was a "substantive" rule to which the notice and comment provisions of the Administrative Procedure Act<sup>14</sup> (APA) and the Federal Energy Administration Act<sup>15</sup> (FEAA) applied or

---

10. 10 C.F.R. § 212.85 (removed 41 Fed. Reg. 15,339 (1976)).

11. In a notice proposing a class exception, 41 Fed. Reg. 33,282 (1976), the Federal Energy Administration recognized that the regulations were interpreted by refiners to authorize a proportional computation of increased product and non-product costs, whether or not all available increased product costs had been recovered first. According to an FEA survey of 104 refiners, there was a substantial cost impact on consumers during the thirteen month period, January 1, 1975, through January 31, 1976, resulting from the different interpretations applied by refiners. In view of the alleged refiner misinterpretations, the FEA claimed that: (1) The amount to be recovered under the "proportional" interpretation of the regulations advanced in the proposed class exception was \$3.6 billion. (2) The amount to be recovered under the "sequential" interpretation of the regulations, requiring pass-through of all increased product costs first was \$2.4 billion. (3) The difference between the proportional and sequential interpretation was \$1.3 billion. [1977] EN. MANAGEMENT (CCH) ¶ 9546.

12. Refiners of regulated petroleum products or covered products are linked to their May 15, 1973 base profit margin. Although refiners may recover increased product and non-product costs by use of the pass through device, the system is not without its disadvantages. For example, as a refiner's costs increase and its sales prices rise, the refiners profit margin becomes a smaller percentage of its gross income. Refiners tied to the 1973 profit margin may lack capital or incentive to expand their production and marketing. Williams, *Monograph 4A*, in 2 ENERGY LAW SERVICE § 4A.06 at 10 (H. Green ed. 1978).

13. The other issues dealt with by the Temporary Emergency Court of Appeals were justiciability, the requirement that refiners recover all product costs first, contemporaneous construction of the rule as requiring refiners to follow the non-product costs last sequence of recovery, and summary judgment. *Standard Oil Co. v. Department of Energy*, 596 F.2d 1029 (Temp. Emer. Ct. App. 1978).

14. 5 U.S.C. § 553 (1976).

15. 15 *id.* § 776.

whether it was an "interpretative" rule and thus exempt from procedural requirements. The Temporary Emergency Court of Appeals held in *Standard Oil* that the FEA was required to adhere to the procedural safeguards of both the APA and the FEAA and that the FEA's post-February "interpretation" of the pre-February rule was, because of ambiguous wording and the FEA's own actions, a substantive change in policy to which these procedures applied.<sup>16</sup>

## II. THE REGULATORY SETTING OF *STANDARD OIL*

### A. *The Regulatory Framework*

The imposition of price controls on crude oil and petroleum products was made in response to an emergency situation, specifically, increases in the price of oil brought on by the Arab oil embargo of 1973 and inflationary trends in the American economy in the early 1970's.<sup>17</sup> Initially, the petroleum industry operated under the same regulations which governed the manufacturing and reselling industries. From 1971 to 1973, the petroleum industry was subjected to the Phase I and Phase II price controls<sup>18</sup> which originated under the Economic Stabilization Act of 1970.<sup>19</sup> This law delegated to the President of the United States the statutory authority to impose a ninety day freeze on prices, rents, wages, and salaries, a measure designed to halt inflation and provide economic stability.<sup>20</sup> The Phase I price freeze limited all prices of goods and services in the economy to their August 15, 1971 levels. Thus, in the petroleum industry the price of gasoline would be frozen

---

16. *Standard Oil* was the result of an appeal by the DOE and a consolidation of multi-district litigation. In Ohio, nine refiners (Sohio, Sun, Mobil, Texaco, Gulf, Shell, Amoco, Arco, and Exxon) instituted suit to prevent the FEA from retroactively applying a new interpretation to an existing rule. The court held for the oil companies. *Standard Oil Co. v. FEA*, 453 F. Supp. 203, 243-44 (N.D. Ohio 1978). In Delaware, six refiners (Phillips, Tenneco, Pennzoil, Coastal States Gas, Conoco, and Amerada Hess) filed similar suits. The Delaware court also ruled for the oil companies in holding that the FEA attempted to change its rules without notice or an opportunity for a hearing, in violation of the APA and the FEAA. *Phillips Pet. Co. v. Department of Energy*, 449 F. Supp. 760, 800 (D. Del. 1978).

17. Erickson, Peters, Spann, & Tese, *The Political Economy of Crude Oil Price Controls*, 18 NAT. RESOURCES J. 787 (1978). OPEC, the Organization of Petroleum Exporting Countries, instituted an oil embargo primarily in response to the Arab-Israeli conflict of 1973 and eventually quadrupled the world price of crude oil. *Id.*

18. Exec. Order No. 11,627, 36 Fed. Reg. 20,139 (1971), *amended*, Exec. Order No. 11,630, 36 Fed. Reg. 21,023 (1971).

19. Pub. L. No. 91-379, tit. II, 84 Stat. 796, 799 (expired under its own terms, Pub. L. No. 93-28, § 8, 87 Stat. 27, 29).

20. *Id.*

at its traditionally high summer price while middle distillates<sup>21</sup> would be frozen at seasonally low prices.<sup>22</sup> In keeping with his statutory authority,<sup>23</sup> the President was authorized to make adjustments "necessary to prevent gross inequities" in allowing for price increases above the August 15, 1971 freeze levels to the extent they reflected cost increases.<sup>24</sup> This adjustment was contained in the Phase IV controls and stated that manufacturers and resellers could recover cost increases but only to the extent of *product* cost increases.<sup>25</sup> When the responsibility for regulating crude oil and petroleum products later shifted from the statutory authority under the Economic Stabilization Act to the Cost of Living Council<sup>26</sup> then to the Federal Energy Office<sup>27</sup> then to the FEA<sup>28</sup> and finally to the Department of Energy,<sup>29</sup> the refiner industry argued that the regulations in effect did not expressly impose a sequence of cost recovery. The oil refiners interpreted the regulations to allow two kinds of recovery; the recovery of non-product cost increases before the recovery of product cost increases or a recovery of both types of costs proportionally. It is this interpretation by the refiners and a contrary one by the FEA, disallowing the recovery of non-product cost increases first, that formed the basis of the dispute between the industry and the government.

Phase IV marked the assertion of tighter control over the petroleum industry.<sup>30</sup> Controls were imposed on production from the oil

---

21. Middle distillates include "Nos. 1 and 2 heating oils, Nos. 1-D and 2-D diesel fuels, kerosene, and aviation fuels." 10 C.F.R. § 212.31 (1980).

22. Erickson, Peters, Spann & Tese, *supra* note 17, at 788.

23. *See* Amalgamated Meat Cutters v. Connally, 337 F. Supp. 737, 744-45 (D.D.C. 1971) (upholding the delegation of the legislative power to the President and the Cost of Living Council, the panel initially responsible for regulating crude oil and petroleum products).

24. *See* notes 19 & 20 *supra*.

25. 38 Fed. Reg. 6283 (1973); HISTORICAL WORKING PAPERS ON THE ECONOMIC STABILIZATION PROGRAM 1261-91 (1975).

26. The Cost of Living Council's petroleum pricing authority was derived from the authority of the Economic Stabilization Act of 1970, 12 U.S.C. § 1904 (1976 & Supp. III 1979). The cost of Living Council was established under Exec. Order No. 11,617, 36 Fed. Reg. 17,813 (1971).

27. Exec. Order No. 11,748, 38 Fed. Reg. 33,575 (1973). The Federal Energy Office was delegated authority to implement the allocation and price stabilization provisions of the Emergency Petroleum Allocation Act, 15 U.S.C. §§ 751-760h (1976).

When petroleum price control responsibilities were transferred, the Federal Energy Office was granted enormous discretion in establishing a price control program. *See, e.g.*, California v. Simon, 506 F.2d 430 (Temp. Emer. Ct. App.), *cert. denied*, 419 U.S. 1021 (1974).

28. 15 U.S.C. §§ 761-786 (1976 & Supp. III 1979). In June, 1974, the President abolished the Federal Energy Office and replaced it with the Federal Energy Administration. Exec. Order No. 11,790, 39 Fed. Reg. 23,185 (1974).

29. The Federal Energy Administration was incorporated into the Department of Energy on October 1, 1977. 42 U.S.C. § 7151(a) (Supp. III 1979).

30. The Phase III program seemed to be a reversal of the Phase I and II policies in that it

well and marketing at the retail gasoline station.<sup>31</sup> According to these controls, refiners could increase product prices above the base level only to the extent they reflected increased crude and purchased product costs on a dollar for dollar basis. This allowed the recouping and passing along of costs to the consumer only as the costs were incurred.

### B. *The Petroleum Price Regulations*

The Phase IV price regulations implemented the basic petroleum price controls in effect between January 1, 1975, and January 31, 1976.<sup>32</sup>

The most important aspect of the price regulations is the base period price level provision. Refiners were permitted to maintain their May 15, 1973 profit margin while recovering increased costs by charging increased sales prices.<sup>33</sup> A refiner's determination of the maximum price it could charge for gasoline during any month began with the price at which gasoline was lawfully priced by the refiner in transactions with the relevant class of purchaser<sup>34</sup> on May 15, 1973. Added to this were increased product costs and increased non-product costs incurred by the refiner between the preceding month and May 1973.<sup>35</sup>

Although a price freeze such as that set out above may work in an emergency situation, it has been argued that a system of price and allocation controls on crude oil and refined petroleum products obscured the economic effects of shortages and stoppages produced by the price controls.<sup>36</sup> This is just one illustration of the nearly constant contro-

---

provided for voluntarily applied price adjustments. This led to such a sharp increase in distillate prices that the Cost of Living Council took measures which reimposed mandatory price controls on the sale of crude and petroleum products. See Erickson, Peters, Spann & Tese, *supra* note 17, at 789.

31. Refiners' base prices were frozen at the May 15, 1973 level. On September 28, 1973, retailer margin levels were frozen at the May 15, 1973 level. *Id.*

32. 38 Fed. Reg. 6283 (1973).

33. As a refiner-seller's costs increase and its sales prices rise, the profit margin becomes a smaller percentage of the refiner-seller's gross income. Note 12 *supra*.

34. A class of purchaser is a group of customers charged a comparable price for comparable goods in light of ordinary price differentials between those customers and other customers. 10 C.F.R. § 212.31 (1980). For example, an independent jobber with whom an oil company has dealt often would receive more favorable price treatment, possibly in the form of regular increased deliveries, than a jobber new to dealing with the company.

35. 41 Fed. Reg. 5110, 5117-23 (1976) (codified in part in 10 C.F.R. §§ 212.31, 212.82-.85, 212.92, 212.132 (1977)).

36. The refiners argued that an "evil" of the price control system was that it set prices so low as to reduce incentives for hard work, innovation or investment. *Standard Oil Co. v. FEA*, 440 F. Supp. 328 (N.D. Ohio 1977). See also Slawson, *Price Controls for a Peacetime Economy*, 84 HARV. L. REV. 1090 (1971). Slawson suggested the removal of price controls and their replacement by a requirement to pay profits in excess of a percentage of equity to the government.

versy between the industry and the regulators. Another example of the differences involves the increased costs provision of the regulations.<sup>37</sup> Under that section, a refiner "may increase" its May 15, 1973 selling prices to reflect the increased costs of imported and domestic crude petroleum. Because of this wording, the Ohio District Court in *Standard Oil* stated that the refiners could either pass through increased product costs by adding them to base prices under the increased costs provision or by banking the costs and passing them through at another time.<sup>38</sup> The FEA argued that the word "may" was misinterpreted by the court and that a fixed base price definition was compelled by the interpretation. On appeal, the Temporary Emergency Court of Appeals found that the FEA did not intend its use of the word "may" to be mandatory.<sup>39</sup> The court ignored the FEA's argument that it was implicit in the regulations that the word "may" was not intended to give refiners the discretion to vary their base prices by including in the base price less product cost increases than required by the cost increase formula.<sup>40</sup>

This conflict between the petroleum industry and the FEA over petroleum price regulations, their form and substance, culminated on February 1, 1976 with the issuance of a regulation<sup>41</sup> in which the FEA, for the first time, explicitly stated a sequence of cost recovery for refiners. It required that all product cost increases must be recovered before non-product cost increases and again established the old rule that all non-product cost increases which were not passed through could not be banked.<sup>42</sup> The conflict caused by this regulation came before the

---

37. 10 C.F.R. § 212.83(c)(1)(i) (1975).

(c) *Allocation of increased product costs*—(1) *General rule*—(i) *Special products*. In computing base prices for sales of a special product, a refiner may increase its May 15, 1973 selling prices to each class of purchaser once each calendar month beginning with November 1973 by an amount to reflect the increased product costs attributable to sales of that special product using the differential between the month of measurement and the month of May 1973 provided that the amount of increased costs used in computing a base price is calculated by use of the general formula set forth in paragraph (c)(2)(i) of this section.

*Id.*

38. *Standard Oil Co. v. FEA*, 453 F. Supp. 203, 225 (N.D. Ohio 1978).

39. *Standard Oil Co. v. Department of Energy*, 596 F.2d 1029, 1043 (Temp. Emer. Ct. App. 1978).

40. *Id.*

41. Sequence of recoupment of costs, 10 C.F.R. § 212.85 (1976) (removed 41 Fed. Reg. 15,339 (1976)).

42. (a) *Refiners subject only to Subpart E*. For purposes of calculating recoupment of increased costs under § 212.83, costs shall be *deemed to have been recovered* in prices charged in a current month "u" *only in the following sequence*:

(1) All increased costs of crude oil incurred during the month two months before



Temporary Emergency Court of Appeals in *Standard Oil*.III. SUBSTANTIVE OR INTERPRETATIVE RULE MAKING IN *STANDARD OIL*A. *Definitional Approach*

Under § 551(4) of the Administrative Procedure Act,<sup>43</sup> a rule is "the whole or part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy describing the organization, procedure, or practice requirements of an agency. . . ."<sup>44</sup> The February regulation under consideration meets the APA's definition of a rule. It stated that all product costs must be passed through into increased purchaser prices before any non-product costs could be similarly passed through.<sup>45</sup>

A substantive rule has been described as the "administrative equivalent of a statute, compelling compliance with its terms on the part of those within the agency ambit."<sup>46</sup> Because substantive rules

the current month ("t=1") and not passed through in the immediately preceding month ("t"),

(2) All increased costs of crude oil incurred in the month of measurement ("t"),

(3) (i) Increased costs of crude oil incurred three or more months before the current month ("u") and not passed through by the immediately preceding month ("t"), *Provided*, That the portion of such amount deemed to have been recovered in the current month ("u") shall not exceed 10 percent of the highest total such amount as of the end of any month prior to the current month "u" (no such costs will exist until March 31, 1976), and

(ii) Increased costs of crude oil incurred through December 31, 1975 and not passed through as of January 31, 1976, and not passed through by the immediately preceding month ("t"), *Provided*, That the portion of such amount deemed to have been passed through in the current month "u" shall not exceed 10 percent of the total such amount as of January 31, 1976,

(4) The amount of increased costs attributable to products purchased after December 31, 1975 and not recovered through the month of measurement ("t"), represented by the symbol "B" in the formulae in § 212.83(c), and

(5) *Increased non-product costs.*

41 Fed. Reg. 5120 (1976) (codified in 10 C.F.R. § 212.85) (removed 41 Fed. Reg. 15,339 (1976)) (emphasis added).

43. 5 U.S.C. § 551(4) (1976).

44. *Id.* Rule making is to be distinguished from adjudication. While adjudication applies to specific individuals, rule making has a "general application to all members of a broadly identifiable class." *American Airlines, Inc. v. Civil Aeronautics Bd.*, 359 F.2d 624, 636 (D.C. Cir.) (Burger, J., dissenting), *cert. denied*, 385 U.S. 843 (1966).

45. Note 48 *supra*. For a description of the rule's provisions, see text accompanying note 48 *supra*. Under 10 C.F.R. § 212.81 (1975), the rule was applicable to all refiners.

46. B. SCHWARTZ, *ADMINISTRATIVE LAW* § 58, at 154 (1976); *cf.* *People v. WidELITZ*, 39 Misc.2d 51, 239 N.Y.S.2d 707 (Sup. Ct. 1963) (defining rule as any type of legislative or quasi-legislative norm prescribing future conduct).

K. DAVIS, *ADMINISTRATIVE LAW TEXT* § 5.03, at 126 (3d ed. 1972), states that using the term "substantive" is misleading because the term also indicates rules that are not procedural and that "legislative" is deemed preferable to designate rules that are not interpretative. *Id.* For purposes

create law by changing existing rights and obligations, they are subject to the APA rule making procedures including publication and an opportunity for the affected group to comment.<sup>47</sup>

In determining whether the February rule was substantive or interpretative, one may attempt to determine whether the rule implemented or interpreted FEA requirements. If the rule implemented the law, it would be a substantive rulemaking to which certain procedural requirements apply.<sup>48</sup> If the rule merely interpreted already existing law or policy, it would be deemed interpretative and the procedural requirements would not apply.<sup>49</sup> Another method used to distinguish between substantive and interpretative rule making involves characterization of the rule. Rules that are new, in the sense that they more than merely clarify uncertainty in an existing statute or regulation, will be

---

of this article, the term "substantive" will be used for several reasons. This was the term used in *Standard Oil Co. v. Department of Energy*, 596 F.2d 1029 (Temp. Emer. Ct. App. 1978). Secondly, the Federal Energy Administration attached the substantive label to the rule making. Finally, the extent of the rule's effect on the industry justifies the label "substantive."

47. 5 U.S.C. § 553(d) (1976).

48. *Id.* § 553(b)-(d).

(b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include—

- (1) a statement of the time, place, and nature of public rule making proceedings;
- (2) reference to the legal authority under which the rule is proposed; and
- (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved. Except when notice or hearing is required by statute, this subsection does not apply—

(A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or

(B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor [*sic*] in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

(c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made on the record after opportunity for an agency hearing, sections 556 and 557 of this title apply instead of this subsection.

(d) The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except—

- (1) a substantive rule which grants or recognizes an exemption or relieves a restriction;
- (2) interpretative rules and statements of policy; or
- (3) as otherwise provided by the agency for good cause found and published with the rule.

(e) Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule.

*Id.*

49. *Id.* § 553(b)(3)(A).

deemed substantive.<sup>50</sup> A third point of distinction deals with delegation. When the legislature has delegated power to the administrative agency to make a rule having the force of law,<sup>51</sup> rules promulgated pursuant to that power must be issued in accordance with procedural requirements.<sup>52</sup>

In *Standard Oil*, the non-product costs last rule was declared substantive, but because it did not comply with procedural requirements it was held invalid.<sup>53</sup> Judge Jameson disagreed with at least one scholar<sup>54</sup> who contended that a court may no more substitute its judgment on the content of a substantive rule than it may substitute its judgment on the content of a statute.<sup>55</sup> This judicial deference doctrine can be explained by the recognition of administrative expertise developed through the implementation and enforcement of statutes and regulations.<sup>56</sup> The *Standard Oil* court gave effect to this doctrine by labeling an agency's interpretation controlling unless it is deemed clearly erroneous.<sup>57</sup> Nonetheless, the Temporary Emergency Court of Appeals made an exception in *Standard Oil* because the FEA's interpretation of the rule was erroneous and inconsistent with FEA regulations, stating that "deference to an agency's interpretation is not a hard and fast rule."<sup>58</sup>

Unlike a substantive rule, an interpretative rule has been defined as a clarification or explanation of existing laws or regulations.<sup>59</sup> Interpretative rules state what an administrative agency believes a statute or regulation already means. It is distinguished from the substantive rule in that courts have extensive powers to review interpretative rules<sup>60</sup> and

50. 596 F.2d at 1061. Because the FEA had not issued a sequence of cost recovery rule prior to February, 1976, the February rule was held to be substantive.

51. B. SCHWARTZ, *supra* note 46, § 59, at 157. Once an administrative agency promulgates regulations, they have the force of law. *United States v. Nixon*, 418 U.S. 683, 695 (1974); *United States v. Mersky*, 361 U.S. 431, 437-38 (1960).

52. B. SCHWARTZ, *supra* note 46, § 59, at 157.

53. 596 F.2d at 1069.

54. K. DAVIS, *supra* note 46.

55. *Id.* § 5.03, at 126.

56. *Udall v. Tallman*, 380 U.S. 1 (1964).

57. 596 F.2d at 1055.

58. *Id.* at 1056 (citing *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944)). "The weight to be given to an administrative interpretation depends upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all of those factors which give it power to persuade, if lacking power to control." *Id.*

In *Standard Oil*, the non-product costs last rule was held invalid due to the FEA's failure to comply with procedural requirements. 596 F.2d-at 1069. In addition to lack of procedure, an administrative rule may be declared invalid if it is unconstitutional or if it was promulgated without statutory authority. K. DAVIS, *supra* note 46, § 5.06, at 137.

59. K. DAVIS, *supra* note 46, § 5.03, at 126.

60. *Id.*

there is no requirement of notice and comment.<sup>61</sup> An interpretative rule is not legally binding, but is merely the agency's construction of the law it is required to administer.<sup>62</sup> Despite being subject to extensive judicial review, interpretative rules tend to acquire great weight through the judicial deference normally paid them by the courts.<sup>63</sup> In *Standard Oil*, the FEA contended that the February ruling was not the legislation of a new law but merely a clarification of what the law had always been and therefore an interpretative rule.<sup>64</sup> This line of argument is questionable because even the FEA admitted that the non-product costs increase last method announced in February was the first explicit statement of such a sequence of cost recovery.

Despite the fervor of the FEA's implicit meaning argument, it was rejected by the Temporary Emergency Court of Appeals<sup>65</sup> and earlier by the Ohio District Court<sup>66</sup> in a decision which labeled the FEA's explanation a "masquerade".<sup>67</sup> The district court also found that prior to the February rulemaking, the FEA did not give notice that it required an all product costs first sequence for the recoupment of increased product and non-product costs.<sup>68</sup> Because the FEA's regulations never expressly addressed an all product costs first sequence of cost recovery during the January 1, 1975 through January 31, 1976 time period, the district court refused to give effect to the FEA's intended meaning before the issuance of the sequence of recoupment of costs regulation.<sup>69</sup>

Although interpretative rules do not of themselves affect legal rights and obligations, there are two factors that increase the weight or

---

61. 5 U.S.C. § 553(b)(3)(A), (d)(1) (1976).

62. B. SCHWARTZ, *supra* note 46, § 55, at 144.

63. 596 F.2d at 1055-56.

64. *Id.* at 1060.

Although FEO believes that its interpretation of the meaning of the language used in the regulations is correct—i.e., increased product costs were required to be recovered first; banking of unrecovered increased non-product costs was not permitted—it nevertheless acknowledges that refiners might have concluded in good faith that recoupment on a proportional basis was permitted as a result of possibly ambiguous language in § 212.83(d) and certain information disseminated by the FEA.

41 Fed. Reg. 33,282, 33,283 (1976).

65. 596 F.2d at 1061.

66. *Standard Oil Co. v. FEA*, 453 F. Supp. 203, 243-44 (N.D. Ohio 1978).

67. In adopting the all product costs first theory of increased cost recovery, the FEA and its predecessor agencies never complied with these procedural requirements. The FEA continues to rely on the masquerade that compliance with these requirements was not necessary because it never changed the implicit requirements of the regulations.

*Id.* at 243.

68. *Id.* at 245.

69. 10 C.F.R. § 212.85 (removed 41 Fed. Reg. 15,339 (1976)).

authoritative effect of interpretative rules: the expertise of the administrative agency combined with the lack of expertise of the court, and the "contemporaneous construction" given the regulation by administrative officials.<sup>70</sup> Because the Temporary Emergency Court of Appeals held that the language of the February regulation along with the language of prior regulations made it a substantive rule, additional factors were not substantially considered in *Standard Oil*.<sup>71</sup>

The definitional problem of substantive and interpretative rule making was given conclusive treatment by the Temporary Emergency Court of Appeals in *Energy Reserves Group, Inc. v. Department of Energy*.<sup>72</sup> This opinion examined an FEA ruling which interpreted the stripper well exemption.<sup>73</sup> The Court held that it was an interpretative ruling exempt from the notice and comment procedures of both the Administrative Procedure Act and the Federal Energy Administration Act. Because the ruling interpreted the statutory stripper well exemption defined in the existing regulation,<sup>74</sup> it was held to be interpretative by the Temporary Emergency Court of Appeals. It did not create "new" law, but merely clarified interpretation of the regulation.

### B. *Procedural Requirements*

Interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice are exempt from the notice and comment provisions of the Administrative Procedure Act.<sup>75</sup> The policy behind the procedural requirements of the Act recognizes that the public deserves a role in the making of rules. The lack of a public role in many instances has resulted in the reluctance of the courts to give administrative agencies total discretion in defining the rule

---

70. K. DAVIS, *supra* note 46, § 5.03, at 127.

71. The factors of administrative expertise and contemporaneous construction do, however, demonstrate how untenable the FEA's position was. Administrative expertise of the FEA is unquestioned, but in the area of petroleum cases, the Temporary Emergency Court of Appeals has developed its own expertise. This would decrease the weight to be given to any FEA rule. *See Shell Oil Co. v. FEA*, 574 F.2d 512 (Temp. Emer. Ct. App. 1978).

More importantly, in the case of the non-product costs last rule, the contemporaneous construction given the regulation by individual FEA officials was inconsistent with the FEA's contentions. *See, e.g., Standard Oil Co. v. FEA*, 453 F. Supp. 203, 212 (N.D. Ohio 1978).

72. 589 F.2d 1082 (Temp. Emer. Ct. App. 1978).

73. The ruling excluded injected wells from well count for the purpose of applying the exemption from allocation and price regulations accorded crude petroleum produced by stripper wells. *Id.* at 1087. A stripper well is defined as one that has an average daily production of 10 barrels per day or less during the preceding 12 month period. 10 C.F.R. § 212.54(c) (1980); 15 TULSA L.J. 597, 603 n.33 (1980).

74. 10 C.F.R. § 210.32 (1974) (deleted 41 Fed. Reg. 4931 (1976)).

75. 5 U.S.C. § 553 (1976).

issued.<sup>76</sup> The Administrative Procedure Act requires that an agency, before adopting a rule, publish notice of the proposed rule<sup>77</sup> and provide interested parties an opportunity to comment on it.<sup>78</sup> Notice is required because the rule making is of little value to the affected parties if it is unannounced in advance. Since administrative agencies are not representative bodies, the opportunity to comment protects private interests.

Although violations of procedural requirements by the Cost of Living Council had been tolerated,<sup>79</sup> a reversal of this position was apparent in *Tasty Baking Co. v. Cost of Living Council*.<sup>80</sup> A Cost of Living Council order which denied Tasty Baking's request for exemption from Phase II regulations limiting Tasty's profit margin was held invalid because the Cost of Living Council relied on regulations promulgated without proper notice several months after Phase II price controls were instituted. The Temporary Emergency Court of Appeals stated that "regulations may stand if the court can take judicial notice of the legislation and the accompanying regulations."<sup>81</sup> Chief Judge Tamm, however, disagreed with the Cost of Living Council's position that the regulations were basically codifications of prior definition and policy.<sup>82</sup> The court carefully weighed the Council's authority stating that Council action was not arbitrary and capricious where administrative control had been congressionally authorized provided there had been a "rational basis" for the agency's conclusions.<sup>83</sup> Seemingly, it is only in cases of "cavalier disregard" of procedural requirements that an administrative agency rule making will be declared invalid.

---

76. A new method of determining whether or not a rule is subject to § 553 procedures has developed. The basis for exemption from rule-making requirements is not the rule's interpretative nature but instead, the rule's importance to those regulated and to the public—the substantial effect. To determine a rule's substantial effect, the courts look to the complexity and pervasiveness of the rule issued, the degree of departure from former practices resulting from the rule, and the confusion created by practical difficulties of compliance with the new rule. Note, *Administrative Law—The Legislative-Interpretative Distinction: Semantical Feinting with an Exception to Rulemaking Procedures*, 54 N.C.L. REV. 421, 425 (1976).

77. 5 U.S.C. § 553(b) (1976) "General notice of proposed rule making shall be published in the Federal Register. . . ." *Id.*

78. *Id.* § 553(c). "After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation." *Id.*

79. *California v. Simon*, 504 F.2d 430 (Temp. Emer. Ct. App.), *cert. denied*, 419 U.S. 1021 (1974).

80. 529 F.2d 1005 (Temp. Emer. Ct. App. 1975).

81. *Id.* at 1014.

82. *Id.*

83. *Id.* at 1011-14.

### C. *Promulgation of the Non-Product Costs Increase Last Rule*

On February 1, 1976, the Federal Energy Administration announced a regulation which required that product costs, including banked costs,<sup>84</sup> were required to be recovered before any non-product costs were recovered.<sup>85</sup> In addition, non-product costs could not be banked for recoupment at a later date. In *Standard Oil*, the refiners contended that no express sequence of recovery rule had been adopted by the FEA prior to February 1, 1976.<sup>86</sup> Throughout the relevant period there was little concern about the sequence of cost recovery by the refiners and the FEA. In its preamble to the February regulation<sup>87</sup> the FEA insisted that the new rule entailed no change in the regulatory framework although it admitted that the prior regulations were silent concerning the order of cost recovery.<sup>88</sup> The FEA acknowledged that the combination of the ban on banking non-product cost increases and the non-product costs increase last sequence of recovery rule would have had several undesirable effects including inflation, disincentive for refiners to build up inventories, and incentive to decrease refinery production.<sup>89</sup> The rule would have compelled refiners to recover all costs currently to minimize absorption and would have forced them to rely on imported, purchased products since refinery production cost increases, including labor and fuel, could not be banked. Subsequently, the FEA proposed a class exception to permit all refiners to recompute their increased cost recoveries during the relevant period using the proportional cost recovery approach.<sup>90</sup> The FEA concluded that refiners in "good faith" may have misinterpreted the regulations to allow recoupment on a proportional basis as a result of ambiguous language in the regulation.

Despite its acknowledgement of hardship on refiners, the FEA ar-

---

84. Note 7 *supra*.

85. 10 C.F.R. § 212.85 (removed 41 Fed. Reg. 15,339 (1976)).

86. Suit was brought against the FEA in Ohio and Delaware challenging the FEA interpretation of cost pass through regulations requiring refiners to allocate monthly sales revenues first to the recoupment of all increased product costs and then to the recoupment of non-product costs. The suits were filed against the FEA after it declined to grant the plaintiff refiners in Ohio and Delaware a class exception from the impact of its ruling. The distinction between the Ohio and Delaware litigation is that all of the Delaware plaintiffs recovered their product and non-product cost increases under the proportional method, while a majority of the Ohio plaintiffs used the non-product costs increase first method. 596 F.2d at 1033-34.

87. 41 Fed. Reg. 5111-20 (1976).

88. Nonetheless, the FEA attempted to assert that the February regulation was identical to the regulations then in effect. 596 F.2d at 1038.

89. 41 Fed. Reg. 15,330, 15,331 (1976).

90. *Id.* at 33,282, 33,283.

gued that the regulations in effect during 1975 and January 1976 "compelled" this sequence of recovery.<sup>91</sup> The Temporary Emergency Court of Appeals distinguished statutory authority from disregard of statutory rule making procedures in finding that the FEA's non-product costs increase last recovery rule was a reasonable interpretation of existing regulations and did not exceed the FEA's statutory authority.<sup>92</sup> The Temporary Emergency Court of Appeals agreed with the Ohio District Court that "had the agency issued regulations which actually embodied that interpretation, pursuant to the required statutory procedures mandating prior publication, notice, and an opportunity to comment, such an interpretation would have been valid for the time frame January 1, 1975 through January 31, 1976."<sup>93</sup> The FEA's all product costs first interpretation was consistent with its statutory authority under the Emergency Petroleum Allocation Act.<sup>94</sup>

In resolving the issue whether the non-product costs increase last rule was substantive or interpretative, the label the administrative agency put upon its exercise of power was indeterminative. What was important was "what the agency did in fact."<sup>95</sup> Because the FEA's action resulted in a new rule with palpable effects upon the petroleum industry, the action should have been substantive and therefore subject to procedural requirements.

#### IV. REFLECTIONS ON JUDICIAL REVIEW

The refiners interpretation of the sequence of cost recovery can be analogized to the injustice of retroactivity in criminal cases. A defendant cannot predict that a later legislative decision will make the conduct in which he engaged criminal. Similarly, the refiners did not receive explicit instructions from the FEA on the method of cost recovery. Because the refiners relied on a tripartite sequence of recovery, the retroactive operation of a rule constricting the methods of cost recovery would be inherently unfair.<sup>96</sup> Indeed, the refiners' challenge to the FEA's statutory authority was successful in *Standard Oil* indicating

---

91. 596 F.2d at 1060.

92. *Id.* at 1069.

93. 453 F. Supp. at 245.

94. 15 U.S.C. §§ 751-760h (1976).

95. *Lewis-Mota v. Secretary of Labor*, 469 F.2d 478, 480 (2d Cir. 1972).

96. *See Great N. Ry. v. Sunburst Oil & Ry.*, 287 U.S. 358 (1932) (holding that a court's refusal to apply the law the court believes to be right to a particular case is not a denial of due process when the court is trying to avoid the undesirable effect of making a change retroactive).



both a search for fairness as well as a new higher level of judicial scrutiny of administrative agency decisions.

Perhaps because the court understood the crisis situation to have passed by 1978, it asserted increased authority over the FEA in the *Standard Oil* decision. The Temporary Emergency Court of Appeals has shown a reluctance to accept "good cause" or other excuses for noncompliance with the procedural requirements of the Administrative Procedure Act and the Federal Energy Administration Act.

## V. CONCLUSION

The February 1, 1976 non-product costs increase last regulation was ambiguous. Confusion and uncertainty existed among both FEA officials and refiners. While the existing regulation could have been reasonably interpreted as imposing a non-product costs increase last sequence of recovery, it was the Temporary Emergency Court of Appeals' opinion that the interpretation was not compelling and could have been construed as imposing no particular sequence of recovery. But because the FEA's post-February 1 interpretation of the pre-February 1 rule was a substantive change in policy to which procedural rules of the Administrative Procedure Act and the Federal Energy Administration Act applied, the FEA's failure to follow the procedures invalidated the February rule.

The court, in deciding the issue of FEA adherence to rule making procedures, followed a three step analysis. First, because the non-product costs last rule was articulated for only the first time it was a "new" or substantive rule; it did not interpret an already existing regulation. Since the refiners had placed much reliance on a non-product costs first interpretation of the pre-February regulation, a similar statutory procedure had to be followed in giving effect to the February regulation. Yet the FEA attempted to effect a rule change without notice or opportunity for comment. In fact, Judge Jameson stated that the regulation was a substantive one and outside the statutory authority of the FEA but it failed because of its procedural defects. Third, because the rule was not validly adopted it could not be made retroactive. A retroactive application would have unduly burdened those refiners who had relied on the non-product costs last sequence of recovery.

## VI. POSTSCRIPT

On January 28, 1981, President Reagan signed an Executive Order<sup>97</sup> exempting all crude oil and refined petroleum products from the Mandatory Price and Allocation Regulations adopted pursuant to the Emergency Petroleum Allocation Act of 1973.

Despite immediate deregulation, the enforcement arm of the Department of Energy remains operative for the period prior to decontrol. The Department has recently settled a number of price control violation cases involving overcharges by major refiners.<sup>98</sup> Pending overcharge cases arising under the *Standard Oil* sequence of cost recovery decision await resolution either through negotiation and refund settlement or through litigation.

---

97. Exec. Order No. 12,287, 46 Fed. Reg. 9909 (1981).

98. *Ten Oil Concerns Settle Charges of Overpricing*, Wall St. J., Jan. 20, 1981, at 10, col. 2.