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Leasehold Pricing For State-Owned Lands: The Medium Is The Mess

by Robert H. Abrams

Cory
v.
Western Oil & Gas Association
(Docket No. 84-16)

Argued February 26, 1985

In this case, the Ninth Circuit Court of Appeals invalidated California's effort to charge lessees of state-owned lands a negotiated price that was calculated according to the level of activity on the leased lands. At first blush, the result seems odd indeed. Why should the Constitution forbid one particular type of price term in a leasehold contract between a state and a private party that desires to lease state land for business purposes? Adding the information that the lands involved are coastal lands and/or tidelands, and that leasing such lands by the oil industry is an operational necessity for receiving oil transported from overseas or from the outer continental shelf insures that the case involves large sums of money. Still, the legal issue is relatively narrow: the possible unconstitutionality of one among many lease pricing mechanisms.

ISSUES

Cory v. Western Oil and Gas Association poses three distinct legal issues. First, it asks the Supreme Court to decide whether leasing state lands at a rate fixed by reference to the amount of goods crossing the parcel is an unconstitutional burden on interstate and international commerce. Second, the case asks whether the same per-unit lease term amounts to a tax on imports in violation of the Import-Export Clause of the Constitution. Finally, the case asks whether the lease arrangement runs afoul of the seldom invoked constitutional prohibition that forbids states from laying a duty on tonnage. The decision of the Ninth Circuit was based alternatively on the Commerce and Import Clauses. Thus, if the decision to invalidate the California pricing scheme is affirmed on either of these grounds, the Supreme Court need not address either of the other possible grounds for affirmance. To reverse, however, the Court must find the lease pricing practice free from constitutional infirmity on all three grounds.

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FACTS

The California State Lands Commission is empowered to issue ground leases for a variety of state-owned lands, including tidelands and uplands along the state's Pacific coast. California, like most coastal states, owns the vast majority of the tidelands immediately adjacent to its shores. The record in the case fixes the total amount of tidelands and submerged lands in California at 3 million acres, of which roughly 93% is owned and regulated by the state. Most of the remaining tidelands and submerged lands are owned and/or extensively regulated by local government units. Tideland ownership extends landward to the mean high tide mark; thus, any enterprise seeking to carry cargo ashore must make use of facilities which extend over, or are built directly on tidelands. Accordingly, the substantial monopoly of the state in its ownership of tidelands renders use of the state-owned land essential to virtually all maritime and pipeline commerce that brings goods to shore from the ocean or from the outer continental shelf.

Companies engaged in offloading cargo own or rent the uplands on which they construct and operate their terminal facilities. By virtue of the state's near monopoly on tideland and submerged land ownership, almost all terminal facilities must negotiate a lease with the state for using state land. This is true even in the case that all of the physical structures are located on privately-owned fast lands located above the high tide mark. To reach the upland, the cargo must cross the tideland. Thus, there is a longstanding pattern of coastal states entering into profitable leases with companies that operate terminal facilities.

In this particular case, the California State Lands Commission (CSLC) in 1976, acting under express legislative authorization, considered adopting an administrative rule that would allow the CSLC to fix the charge for ground leases of state-owned lands on a basis that reflected the volume of activity on the leased parcel. The extensive administrative hearings held prior to adopting the rule established that per-unit lease charges were used in many commercial ground leases, even when the property was leased in an unimproved state. The rule finally adopted by the CSLC authorized per-unit lease charges negotiated with the lessee on a lease-by-lease basis. A number of oil companies operating marine terminal facilities in California appeared before the CSLC to oppose the rule.

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After the rule was adopted, several oil companies and their industry association, the Western Oil and Gas Association, filed a federal lawsuit seeking a declaratory judgment that the rule violated the federal constitution. The suit also raised issues of state administrative law that were ultimately determined in favor of the CSLC. (*See*, 105 Cal. App.3d 554, 164 Cal. Rptr. 468 (1980).) The federal district court, in an unreported decision, found that the California per-unit pricing scheme for leases violated the Constitution by imposing the precise type of "trade barrier" that the Commerce Clause, the Import-Export Clause and the Tonnage Clause were collectively intended to prevent. California was enjoined from assessing or collecting leasehold rents on that basis. As noted above, the Ninth Circuit Court of Appeals affirmed that decision. (*See*, 726 F.2d 1340 (1983))

BACKGROUND AND SIGNIFICANCE

This appears to be a very significant case, although the reasons for that conclusion require elaboration. Implicit in a victory for California is the threat that all coastal states will jump on the bandwagon and collect sizable rents from tideland rentals. This will be an expensive turn of events for American consumers. By winning the case, California would win the ability to fix lease charges on a per-unit basis, for example, at $1 per barrel of oil that crosses the leased property. No doubt many barrels of oil enter the United States in California—each of which could cost $1 more as a result of a California victory.

There are, however, reasons to think that even a California victory in the case is of trivial consequence. In essence, the state already has the power to extort payment for granting the lease that bears no relation to the value of the leased land. All that is at stake is the constitutionality of one additional pricing scheme by which the state can exact its money. The real power of the state does not lie in the pricing mechanism; the real power is the state's monopoly ownership of lands necessary for some facets of all terminal operations—the land between the shore and open water.

The critical determinant of the significance of the case lies in the question: "Is there something about per-unit charges that dramatically increases the leverage of the coastal states beyond that which they already have in setting lease prices?" At first glance, the answer seems to be no, that little leverage is gained by the state. The four examples of CSLC "throughput charges" (per-unit lease pricing) cited as epitomizing the constitutional evil are instances of the state using its bargaining power more than instances in which per-unit lease pricing provides a unique advantage to the state. In all of the examples, the CSLC was in the process of renegotiating a lease with refinery operators already having huge capital investment in their oceanside plants. The largest of these plants, for example, was built at a cost of $723,000,000. Obviously, the refiner will agree to pay almost any new, higher rent California chooses to charge rather than lose the ability to supply the refinery with raw products for processing.

Looking again at the four examples, the real objection of the oil and gas industry seems to be premised on the unfairness of the state being able to charge a rent unrelated to the actual value of the land being leased. Under the pre-1976 lease pricing rules, the basic annual lease charge was 8% of the appraised value of the unimproved industrial land. After adding throughput charges as part of the renegotiation process, the state's percentage return in the four cases ranged from 18% to 28% of the land value. Before concluding that these increases represent an immense burden on the consumers of oil products, it is important to note how reasonable, in dollar terms, those figures are in relation to the value of the refinery enterprises. In the example having the largest percentage increase, the annual rent went from $32,000 to something near $110,000. If the plant involved cost hundreds of millions of dollars to construct, the increased lease cost is a trivial part of the cost of production. If California wished to be the consummate monopolist in its dealings with the "captive" refineries, the new lease price terms would have been much higher without regard to how the price was set.

Further examination of the differences between per-unit lease pricing and other lease pricing mechanisms offers only speculative reasons for the particular antipathy to per unit charges. Possibly the industry does not want the state or competitors to have ready access to the data concerning their quantity of operation at the plant. A second possibility is that the per-unit pricing scheme offers the state an unusually easy way to be sure that it charges a very high price, but still a price that the market will bear. Perhaps most plausibly, this case is but the first step in a long-term strategy of the affected industries to force the coastal states to refrain from charging prices for leases in excess of values that relate only to the value of the lands actually leased. The success of such a strategy would limit the monopoly power of the states to set prices at whatever level the market will bear.

Despite the difficulty in ascertaining the practical importance of this particular form of lease pricing arrangement, the legal issues in the case are fairly significant to the development of the law in regard to all three of the constitutional grounds presented in favor of invalidation. The Commerce Clause analysis is important because in other contexts evenhanded levies on goods moving in interstate commerce have been upheld occasionally (*see, e.g.*, *Commonwealth Edison v. Montana*, 453 U.S. 609 (1981) (tax on stripmined coal almost all of which was destined for interstate shipment)), and have been struck down occasionally. (*See, e.g.*, *Eureka Pipe Line Co. v. Hallanan*, 257 U.S. 265 (1921)) Additionally, the case offers the Court another opportunity to discuss the

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controversial "market participant" doctrine by which states engaged in market activities are freed from some of the constitutional strictures forbidding discrimination against interstate commerce. In regard to the Import-Export Clause, there is great uncertainty about what forms of state exaction are constitutionally permissible general taxation and what forms of exactions are simply burdens on the privilege of bringing property or goods into the country. Finally, the Tonnage Clause has so seldom been a ground of decision, its invocation might signal a new line of decision in cases of this type.

ARGUMENTS

For Cory, Members of the California State Lands Commission *(Counsel of Record, Dennis M. Egan, 6000 State Building, San Francisco, CA 94102; telephone (415) 557-3650)*

1. States as lessors of the state's real property are not subject to strictures greater than those which apply to other lessors.
2. The state in this case involving the lease of state property has acted as a market participant and not as a regulator of commerce and is free to fix the terms on which it will deal with other parties.
3. The rents charged by the CSLC have been fair market rents and involve no discrimination against either international or interstate commerce.
4. The monopoly position of the state in renegotiating ground leases with existing lessees improperly measures the relevant market for such rentals at the time of lease renegotiation rather than at original negotiation.
5. The per-unit pricing by the CSLC is a reasonable rental form and therefore does not violate the Commerce Clause.
6. The state is not limited to rental fees that attempt to recoup only the state's out-of-pocket expenses as might be the case with an inspection fee.
7. The charges involved in this case are clearly rents and not taxes and are not subject to the same scrutiny as are taxes.

For Western Oil & Gas Association *(Counsel of Record, Philip K. Verlanger, 800 Wilshire Boulevard, Los Angeles, CA 90017; telephone (213) 624-4800*

1. The Constitution denies the states the power to collect a charge on goods entering into the state as is done by per-unit charges for ground leases.
2. The market participant doctrine does not apply to this case because to do so offends the policy of the Commerce Clause and allows the state to evade constitutional strictures.
3. The market participant doctrine cannot be applied to this case because there is no market in lands available for terminal sites other than those controlled by the state.
4. A tidelands lease throughput (per-unit) charge is inherently discriminatory against interstate and foreign commerce because almost no intrastate commerce is likely to be shipped by sea.

AMICUS ARGUMENTS

In Support of Cory

The cities of Santa Monica, Culver City, Torrance and Huntington Beach filed an amicus brief raising the following concerns:

1. The state in leasing land is a market participant, not a regulator constrained by the dormant Commerce Clause.
2. The state is not deprived of its market participant status as a monopolist because it does not enjoy a monopoly in the relevant market, and even if it did, its activities would be subject to review under laws concerned with that subject—not constitutional issues of regulation and taxing.
3. The Commerce Clause does not require a state to enter into a contract with a private party on terms calculated to promote interstate commerce.

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