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WHAT PRICE, GAS?

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The gas royalty clause has become one of the more ambiguous oil and gas lease provisions. Issues involving title to the gas, classification of condensate and casinghead gas, and compensation for royalty gas based upon market value, market price or proceeds together with the problem of expense allocation have been well litigated in the courts. A more recent controversy has arisen over the valuation of royalty due the lessor on gas which has been committed under long-term gas sale contracts. Presuming the royalty provisions to be a "market value" clause, should compensation be based on the contract price to which the lessee is committed or the current market value in the area? The law in Texas appears to be the latter, the result of a highly contested supreme court decision[1] which finds support in two prior Fifth Circuit cases.[2] These three cases necessitate a discussion of the legal issues involved to expose the unfortunate consequences which may follow.

Briefly stated the problem is this: If the lessee brings in a gas well, he is under a duty to market that gas with due diligence which, because of the nature of the product, must be under a long-term contract. The purpose of such contracts is to assure the purchaser of a sufficient quantity of gas to finance the construction of pipelines. At the time of execution, the contract price and the current market value will be closely in line and the lessee is able to account for the lessor's royalty accordingly. This has been the common practice for quite some time. During the fifties and sixties, however, the price of natural gas rose gradually until in recent months the price per million cubic feet (mcf) has literally quadrupled in some fields. The lessee is nevertheless bound by his contract price in the absence of an escalation or price adjustment clause—contained in few, if any, of the older contracts still in force—while the royalty owners seek compensation based on current values. The lessee finds himself in an untenable position which is not altogether a web of his own weaving.

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1. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968) (5-4 decision).
2. J.M. Huber Corp. v. Denman, 367 F.2d 104 (5th Cir. 1966); Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84 (5th Cir. 1966).

Contract Price is not Market Value

Texas Oil & Gas Corp. v. Vela[3] involved a suit by lessor against the working interest owners to recover gas royalty deficiencies. An oil and gas lease was executed in 1933 whereby the lessee was obligated to pay the lessor royalty on gas of "one-eighth of the market price at the wells" and in 1935 the lessee entered into a "life of the lease" gas sale contract by the terms of which the gas was "sold" at a price of 2.3¢ per million cubic feet. At the time the gas purchase contract was executed, there was no pipeline into the field and consequently no market for the gas. Therefore, the lessee could market its gas only under such a contract and the price of 2.3¢ per mcf was the only price which could be obtained under the circumstances.[4] Royalties were paid on that basis, although more recent contracts for gas in the same area provided for substantially higher prices. The royalty owners sought to recover this difference alleging that the royalty payments should be based on the current market price of the gas in the area and not the 1935 contract price. In finding for the lessors, the supreme court relied heavily on *Foster v. Atlantic Refining Co.*,[5] a Fifth Circuit case interpreting an atypical royalty clause[6] unlike the one in the *Vela* lease. Royalty obligations, the court reasoned, must be determined from the lease itself, which was executed prior to and independently of the gas sales contract. Since the lessors were not parties to the contract, its terms did not change lessee's obligation under the lease. Pointing to the royalty clause requiring the lessee to pay one-eighth of the market price at the well the court said:

> This clearly means the prevailing market price at the time of the sale or use. The gas which was marketed under the long-term contracts in this case was not 'being sold' at the time the contracts were made but at the time of the delivery to the purchaser.[7]

The contract price together with other circumstances and comparable sales must all be considered to determine the market price which is not

3. 429 S.W.2d 866 (Tex. 1968).

4. *Id.* at 870. While the prices have increased substantially in recent years, the circumstances surrounding the execution of gas purchase contracts remains essentially unchanged.

5. 329 F.2d 485 (5th Cir. 1964).

6. The Foster lease provided that royalty on gas be accounted for "at the market price therefor prevailing for the field where produced *when run*." *Id.* at 488 (emphasis added). The addition of the words "when run" indicated that the parties to the lease intended for the royalty on gas to be accounted for at the market price when produced and no other time, such as time of execution of the gas purchase contract.

7. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968).

necessarily the contract price for which the gas was sold by lessee.[8] As concluded in *Foster*, the majority found no merit in the argument that the lease obligation may prove financially burdensome to the operators. Today, this result will not only prove financially burdensome, but may well find the royalty share higher than that of the entire working interest.

Shortly before *Vela*, two companion cases arising out of Texas were handed down by the Fifth Circuit holding similar to *Foster*, but interpreting the standard type royalty clause.[9] In *J.M. Huber Corp. v. Denman*,[10] as a condition precedent to the execution of the lease, lessee was obligated to obtain a positive gas sale contract with a pipeline company. A life of the lease contract was executed providing for a fixed price of 4¢ per million cubic feet for the first 10 years and then renegotiated to 11¢ per mcf for the duration. The lessee contended this gas had a specific market which was the negotiated contract and this in turn determined the "market price" under the lease. Furthermore, it was contended that the lessors could not claim there was another market other than the contract since the lessors affirmatively participated in the commitment of the gas to the contract. The court rejected this theory, holding that the precondition of the contract for the sale of gas was not inconsistent with the expectation that in the future lessors may want payment for royalty based on the current value of gas delivered.

The facts in *Vela* presented a matter of first impression in Texas, its issue being one of substantive state law. A later federal case admitted the possible inequity of the result but pointed out that federal courts sitting in a diversity action are bound by the substantive law of the state.[11] Unless or until *Vela* is overruled or distinguished, the producers are going to be caught in an increasingly burdensome situation as the price of natural gas escalates. As the stage appears set for

8. *Id.* at 878 (dissenting opinion).

9. J.M. Huber Corp. v. Denman, 367 F.2d 104 (5th Cir. 1966); Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84 (5th Cir. 1966). Both were remanded to the Federal Power Commission for a determination of whether it would assert jurisdiction over accounting for lease royalties.

10. 367 F.2d 104 (5th Cir. 1966). As in Foster v. Atlantic Ref. Co., 329 F.2d 485 (5th Cir. 1964), the court in *Huber* was confronted with an atypical situation whereby the gas purchase contract was entered into before the oil and gas lease was even executed.

11. Placid Oil Co. v. FPC, 483 F.2d 880, 911 (5th Cir. 1973); Duke v. Sun Oil Co., 320 F.2d 853, 858 (5th Cir. 1963); *see* Erie R.R. v. Thompkins, 304 U.S. 64, 74-78 (1938).

further litigation but with much higher stakes,[12] an analysis of the issues involved with a projection which may allow the courts to distinguish the holding in *Vela* will be useful.

Market Value or Contract Price?

In complying with both the obligations imposed under the lease and the standard practices in the industry, the lessee is hard pressed indeed to meet the further burden of royalty payments in accordance with the above cases. The first issue which arises in the problem under consideration involves the implied covenant to market. In the absence of an express provision relating to production and marketing, there is an implied covenant under an oil and gas lease placing a duty on the lessee to market the products produced.[13] As long as there is production in paying quantities,[14] the lessee must exercise due diligence in obtaining a market within a reasonable time,[15] as otherwise the lessor would not realize any benefit from the lease. Failure to market when it would be feasible to do so gives rise to an action at law for damages,[16] although a suit in equity for a conditional decree of cancellation may arise if the remedy at law is inadequate.[17] Either possibility makes it more or less imperative that the lessee secure a market for the gas whenever it would be provident to do so.

12. In response to the recent rapid increase in the price of natural gas, suits have been filed by the Attorney General against 15 major oil companies to recover the fair market value or "in kind" gas royalties from production on state-owned lands. *Thrust and Focus of Attorney General's Office*, 37 TEX. B.J. 23, 26 (1974).

13. Wolfe v. Prairie Oil & Gas Co., 83 F.2d 434, 437 (10th Cir. 1936); Cole Petrol. Co. v. United States Gas & Oil Co., 121 Tex. 59, 64, 41 S.W.2d 414, 416 (1931); Poe v. Humble Oil & Ref. Co., 288 S.W. 264 (Tex. Civ. App.—Eastland 1926), *rev'd on other grounds*, 29 S.W.2d 1019 (Tex. Comm'n App. 1930, jdgmt adopted); M. MERILL, COVENANTS IMPLIED IN OIL AND GAS LEASES 212 (2d ed. 1940); *see* Decker, *Covenants Implied in Oil and Gas Leases*, 42 MICH. STATE B.J. 21, 25 (1963).

14. Clifton v. Koontz, 160 Tex. 82, 89, 325 S.W.2d 684, 691 (1959); Garcia v. King, 139 Tex. 578, 164 S.W.2d 509 (1942). "Paying quantities" is usually defined as production which will return a profit to the lessee, however small, over current production costs.

15. What is a reasonable time is a question of fact. Masterson v. Amarillo Oil Co., 253 S.W. 908, 914 (Tex. Civ. App.—Amarillo 1923, writ dism'd). The reasonable time will be measured under the reasonable prudent operator standard. Brewster v. Lanyon Zinc Co., 140 F. 801, 814 (8th Cir. 1905); *accord*, Freeport Sulphur Co. v. American Sulphur Royalty Co., 117 Tex. 439, 455, 6 S.W.2d 1039, 1044 (1928).

16. Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 518, 19 S.W.2d 27, 29 (1929); Freeman v. Magnolia Petrol. Co., 165 S.W.2d 111, 114 (Tex. Civ. App.—Amarillo 1937), *rev'd on other grounds*, 141 Tex. 274, 171 S.W.2d 339 (1943).

17. Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 518, 19 S.W.2d 27, 29 (1929); Freeport Sulphur Co. v. American Sulphur Royalty Co., 117 Tex. 439, 458, 6 S.W.2d 1039, 1045 (1928); Stanolind Oil & Gas Co. v. Barnhill, 107 S.W.2d 746, 748 (Tex. Civ. App.—Amarillo 1937, writ ref'd).

The practicalities of the gas industry, however, require that gas be marketed under long-term contracts since, unlike oil, gas cannot be stored in tanks at the well head. Only by means of a gas sales contract can the purchaser be assured of a committed supply sufficient to finance the construction of pipelines to the well. For this reason, such contracts are usually for a term coexistent with the "life of the lease" or more commonly for a fixed term of 20 years or more. It has never been feasible for producers to conduct business with gas sales based on a price which may fluctuate at frequent intervals. The courts recognize this condition and readily admit that rules of daily sales and spot quotations have no application in the gas industry.[18] The fact that they recognize this situation, however, has not appeared to have any bearing on their decisions. Prior to *Vela*, it had never been seriously questioned that as long as the lessee had used reasonable diligence in securing the best contract possible, his obligaton to the lessor was fulfilled if the lessor received his royalty fraction under the lease.[19] The lessee, at the same time, is absolutely bound by the terms of the contract upon execution. When the *Vela* gas was committed to the contract, the concepts of "favored nations" clauses[20] or periodic escalation clauses were virtually unknown and hardly available to the lessees. Even today producers are deprived of favored nations clauses when selling gas into interstate commerce. Present and future leases may well provide for price adjustments or accounting based on proceeds of the sale, but the older type clause will be with us for some years.

In executing the gas purchase contract, the lessee at that point has fulfilled his duty to market but there remains an express obligation to pay royalty based on the market value when that type clause is used and although there are cases which distinguish the two, market value and market price are essentially equivalent.[21] In calculating this roy-

18. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964) (no evidence of daily quotations); Phillips Petrol. Co. v. Bynum, 155 F.2d 196, 198 (5th Cir. 1946).

19. Even in *Vela* the court found that the gas purchase contract was executed in good faith. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 876 (Tex. 1968).

20. A "favored nation" clause is a provision in a gas purchase contract increasing the price to be paid for natural gas by a purchaser to the seller producer if any producer in the field receives a higher price for his gas than that stipulated in the contract.

21. Phillips Petrol. Co. v. Johnson, 155 F.2d 185, 188 (5th Cir.), *cert. denied*, 329 U.S. 730 (1946); Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409 (5th Cir.), *cert. denied*, 323 U.S. 737 (1944); Hugoton Prod. Co. v. United States, 315 F.2d 868, 874 (Ct. Cl. 1963). *See also* Bowker v. Panhandle E. Pipe Line Co., 169 F. Supp. 713, 716 (D. Kan. 1959). There is a further discussion of the definition of market value in Brown, *Royalty Clauses in Oil and Gas Leases*, in SIXTEENTH SW. LEGAL FOUNDATION INSTIT. ON OIL & GAS L. & TAXATION 139, 151 (1965).

alty obligation, the crucial issue becomes *when* to determine market price. Admittedly, this price should be determined with respect to the time when the gas is sold. Looking to the four corners of the lease, nothing in the royalty clause suggests when the "sale" is made. Looking to the intent of the parties, the nature of the industry, and purpose of the lease, it is reasonable to presume the gas is sold when it is committed to the long-term contract. Any other construction would result in a "new sale" occurring every day, with the attendant market price fluctuations. It is unlikey that the parties would intend such an outcome.

In somewhat inconsistent reasoning, the majority in *Vela* determined that the price was to be based on market values represented by gas purchase contracts and not by daily quotes, but then went on to hold on the basis of more current fortuitous contracts. As noted by one author, "the contract selling price of gas provides the proper basis for royalty, not so much because it was the actual selling price, but rather because it represents the market price at the time the reserves were commited to the contract."[22] The theory relied upon in *Vela* was that the gas was not "sold" until it was actually delivered to the purchaser, but such reasoning is based on *Martin v. Amis*,[23] which involved a dispute over the title to the gas in question. But title is not controlling since "[i]t has been uniformly held . . . that the word 'sold' does not necessarily in all connections mean that a conveyance must be made or that the title must pass."[24] But the contract of sale and delivery are required to constitute a sale; delivery alone is not a sale for purposes of market price, or else each day's delivery would constitute a separate sale of gas for which a different market price may result. A much more realistic conclusion, or one more in keeping with the nature of the product, is that consummation of a long-term contract for the sale of gas to the pipeline company constitutes a present "sale" for future delivery. Thus, subsequent fluctuations in field prices should not have any effect on the price used by the producer in determining royalty payments inasmuch as this price was set at the con-

22. Lewers, *Primary Jurisdiction and the Royalty Owner: A Misapplied Doctrine*, 23 Sw. L.J. 454, 455 (1969).

23. 288 S.W. 431 (Tex. Comm'n App. 1926, jdgmt adopted). *See also* Ashby v. Delhi Gas Pipe Line Corp., 500 S.W.2d 686, 691 (Tex. Civ. App.—San Antonio 1973, writ dism'd).

24. Seabrook Ind. School Dist. v. Brown, 195 S.W.2d 828, 830 (Tex. Civ. App.—Galveston 1946, writ ref'd); Sanderson v. Wellsford, 116 S.W. 382, 385 (Tex. Civ. App. 1909, no writ).

summation of the gas purchase contract.[25]

Having marketed the gas through a long-term contract and even conceding the gas is sold, the lessor may argue that he was not a party to the contract and therefore is not bound by its terms. This overlooks the duty of the lessee to market with due diligence. If the lessor is legally entitled to demand the earliest possible marketing of the gas, and to penalize the lessee by suit for damages if lessee delays in finding a market, then the lessor should be bound, for purposes of royalty payments, by the best price available to the lessee at the time the gas is marketed. Being a part of the lease itself, the implied covenant to market is equally binding contractually on the lessee and the lessor/royalty owner. For this reason the lessor should likewise be bound by the gas purchase contract which he requires the lessee to execute for the lessor's benefit. This is especially true of the situation presented in *Huber*, where the lessor required the lessee to secure a contract as a precondition to executing the lease. As previously noted, the lessor realizes no benefit from the lease without marketing the gas.

The execution of a division order may or may not have an effect on the payment of royalties resulting from the changed market values. A division order stipulates the price and dates payments are to be made by the purchaser to the various interest owners. The ordinary division order is revocable at will by any party,[26] but it does establish a contractual relationship which is binding on the parties until withdrawn.[27] Its effect is to estop the person signing from claiming any more of the proceeds from the sale than specified in the division order, but it does not, however, effect a permanent estoppel.[28] It is problematical whether specific reference to the gas sales contract will give permanence to the division order.[29] A gas purchase contract, however, might

25. *See* Bounds, *Division Orders*, in FIFTH SW. LEGAL FOUNDATION INSTIT. ON OIL & GAS L. & TAXATION 91, 95-96 (1952).

26. Malarnee v. Pauline Oil & Gas Co., 271 P. 937, 938 (Okla. 1928); Welch v. Pauline Oil & Gas Co., 271 P. 651, 652 (Okla. 1928).

27. *See* Chicago Corp. v. Wall, 156 Tex. 217, 222, 293 S.W.2d 844, 847 (1956); Pan American Corp. v. Vines, 459 S.W.2d 911, 912 (Tex. Civ. App.—Tyler 1970, writ ref'd n.r.e.).

28. *See* Bounds, *Division Orders*, in FIFTH SW. LEGAL FOUNDATION INSTIT. ON OIL & GAS L. & TAXATION 91, 104 (1952).

29. Inasmuch as the gas sales contract precedes the division order, it is doubtful that such contract would be binding upon the lessor absent any consideration. There is authority, however, that when a division order contains a specific reference to the contract under which the gas is being marketed, it is not revocable but continues in force as long as the gas sales contract continues. *See* Union Prod. Co. v. Driskell, 117 F.2d 229, 231

be ratified and binding upon the royalty owner for the term of the lease provided there is some consideration passing between the parties.

While both *Huber* and *Weymouth v. Colorado Interstate Gas Co.*[30] resolved the issues of increased royalty payments based on current market value in favor of the lessors, the larger issue in each of those cases involved the jurisdiction of the Federal Power Commission over gas rates running to the royalty interests. Unlike *Vela*, interstate sales were involved with both cases remanded for a determination of the jurisdictional issue. Originally holding natural gas royalties jurisdictional pursuant to the Natural Gas Act,[31] this order was reversed in *Mobil Oil Corp. v. Federal Power Commission.*[32] The gas royalty proceeds arising out of a typical lease are not properly equated with jurisdictional sales for resale under the Natural Gas Act nor are the lessors jurisdictional natural gas companies subject to the Act even though the lessee may commit all the gas in a jurisdictional sale. While this may be true under the Natural Gas Act, the result is that producers are bound by the FPC ceiling with the royalty owners free to demand that gas be accounted for on current market values quite above these ceilings. Problems arising under the Natural Gas Act are beyond the scope of this paper, but the *Mobil* decision has significant implications relating to the problem here.

Construction of a Slightly Varied Royalty Provision

Having examined the legal issue presented in the *Vela* situation, what may lessees with similar lease provisions and committed gas sales expect in the future? "Similar lease provisions" is somewhat misleading as very minimal differences in clause language among several lease forms may result in extremes of cancellation or continuation. Since minimal variations or omissions in wording may result in completely opposite holdings,[33] the large number of disputes concerning proper

(5th Cir. 1941); Simpson v. United Gas Pipe Line Co., 17 So. 2d 200, 202 (Miss. 1944). *See also* 4 H. WILLIAMS, LAW OF OIL & GAS § 704.4, at 666-67 (1972).

30. 367 F.2d 84 (5th Cir. 1966).

31. Denman v. J.M. Huber Corp., 42 F.P.C. 164 (1964). *See generally* Lewers, *Primary Jurisdiction and the Royalty Owner: A Misapplied Doctrine*, 23 Sw. L.J. 454 (1969).

32. 463 F.2d 256, 258-59 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972); *see* Placid Oil Co. v. FPC, 483 F.2d 880 (5th Cir. 1973), holding that royalty obligations are beyond the control of the FPC which is not willing to alter area-wide gas rates merely because there is a possibility that the royalty obligations might require a greater portion of the rate than the FPC thought.

33. Gulf Oil Corp. v. Reid, 161 Tex. 51, 54-55, 337 S.W.2d 267, 269-70 (1960); *cf.* Skelly Oil Co. v. Harris, 163 Tex. 92, 97, 352 S.W.2d 950, 953 (1962).

construction is not surprising. Construction of an oil and gas lease to determine its legal effect involves a question of law for the court which excludes parol evidence and differs from interpretation of the meaning of the language used. Although a little of both may be involved in the present situation, it follows that a slight variation in the royalty clause will leave the courts free to construe the effect of such changes and rule accordingly. Any number of variations are possible but construction of an "in kind" gas royalty clause is particularly meaningful, and relevant to this discussion.

The theory underlying in kind delivery of royalty gas is to retain title to that portion in the lessor, and any sale would necessarily be on behalf of the lessor.[34] With such a provision it would appear that an agency type relationship arises, although there is authority that the lessee does not occupy the position of a trustee in that his duty is contractual rather than fiduciary.[35] Notwithstanding an in kind provision with the consequent retention of title, the difficulty of storing gas and making an in kind delivery without special arrangements by the lessor suggests that the lessee has authority to sell the royalty gas. In the case of the royalty oil such authority has been expressly resolved in favor of the lessee.[36] An even stronger argument can be made with respect to gas given the nature of the product along with lessee's implied obligation to market. This duty, furthermore, must include the authority to commit all the royalty gas to long-term gas purchase contracts since there exists no viable alternative marketing method. In entering such contracts it has been held that the lessee is to exercise the utmost good faith in disposing of the royalty owner's gas.[37] This apparently is no different from ordinary good faith,[38] however, and it is well established that the standard of care owed by a lessee in the exercise of implied and express covenants under the lease is measured by that of the reasonably prudent operator.[39] If there is a difference in the nature of

34. 3 E. KUNTZ, LAW OF OIL & GAS § 40.3, at 298 (1967); *see* Phillips Petrol. Co. v. Ham, 228 F.2d 217 (5th Cir. 1955); Kretni Dev. Co. v. Consolidated Oil Co., 74 F.2d 497 (10th Cir. 1934), *cert. denied*, 295 U.S. 750 (1935).

35. LeCuno Oil & Gas Co. v. Smith, 306 S.W.2d 190, 192 (Tex. Civ. App.—Texarkana 1957, writ ref'd n.r.e.), *cert. denied*, 356 U.S. 974 (1958); Comment, *The Lessor's Remedies for Nonpayment of Royalty*, 45 TEXAS L. REV. 132, 138 (1966).

36. Wolfe v. Prairie Oil & Gas Co., 83 F.2d 434, 437 (10th Cir. 1936).

37. LeCuno Oil & Gas Co. v. Smith, 306 S.W.2d 190, 192 (Tex. Civ. App.—Texarkana 1957, writ ref'd n.r.e., *cert. denied*, 356 U.S. 974 (1958).

38. *See* Greenshields v. Warren Petrol. Corp., 248 F.2d 61, 66-67 (10th Cir.), *cert. denied*, 355 U.S. 907 (1957); Gex v. Texas Co., 337 S.W.2d 820 (Tex. Civ. App.—Amarillo 1960, no writ).

39. Williams, *The Fiduciary Principles in the Law of Oil and Gas*, in THIRTEENTH SW. LEGAL FOUNDATION INSTIT. ON OIL & GAS L. & TAXATION 201, 216 (1962).

the duty owed in marketing the lessee's gas as opposed to the lessor's conceptual royalty portion, it remains largely undefined.

Just as the lessee is not required to provide tanks for delivery of royalty oil, neither is he required to construct feeder lines at his own expense in order to deliver lessor's royalty gas to the pipelines.[40] Without any provision for storage or transport made by the lessor, the lessee will be obliged to market all the gas himself pursuant to a gas purchase contract. Given this situation the issue may be restated: If there does exist such an in kind provision in the lease, but lessor accepts proceeds under a gas sales contract, may the lessor later exercise an in kind right for the duration or must he accept the lessee's sale? Under these circumstances the lessor could be said to have waived any right to delivery in kind. With respect to oil, such waiver would only apply to past production and would not preclude insistence upon full compliance with the royalty provision in the future,[41] absent any elements of estoppel or ratification of a new and substituted agreement. This is not true of gas, however, which has been committed to the contract. If the lessor acquiesces in marketing royalty gas pursuant to such contract, he should be treated as having waived his in kind right for the duration of the contract. In *Gex v. Texas Co.*,[42] the grantors conveyed certain lands together with an option to drill at grantee's discretion but reserved the right to take royalties "in kind" on any oil and gas produced. The grantors sought royalty payments in kind some years after the conveyance, but the court denied recovery, basing its decision on the intent of the parties. Taking judicial notice of the fact that gas, unlike oil, is usually purchased under life of the lease or long-term contracts, the court held that defendants at least had the implied authority to market the gas for the mutual benefit of the parties since plaintiff grantors failed to provide pipelines and storage facilities for delivery in kind.

The lessor may also waive his in kind right for the duration of the contract if he enters into any type of pooling or unitization agreement. The court in *Phillips Petroleum Co. v. Ham*[43] reasoned that the execu-

40. 3 E. KUNTZ, LAW OF OIL & GAS § 40.3, at 319 (1967); *see* Krenti Dev. Co. v. Consolidated Oil Co., 74 F.2d 497, 500 (10th Cir. 1934), *cert. denied*, 295 U.S. 750 (1935); *cf.* Cameron v. Stephenson, 379 F.2d 953, 956 (10th Cir. 1967).

41. Clark v. Slick Oil Co., 211 P. 496, 500 (Okla. 1922). This construction is reasonable with regard to oil since it can be readily stored at the well site without excessive efforts or outlay on the part of the lessee. Thus with oil, there should be a continuous option or right to elect to take in kind on the future despite a waiver of such right in the past.

42. 337 S.W.2d 820 (Tex. Civ. App.—Amarillo 1960, no writ).

43. 228 F.2d 217 (5th Cir. 1955).

tion of a communitization agreement by the lessor was inconsistent with his right to take royalty gas in kind and "having, by pooling the leases into one, obtained the benefits thereof, [lessor] . . . cannot some four years later make a claim to receive in kind a ratable proportion of the gas."[44] It is significant to note the court considered the acceptance of proceeds under the pooling agreement as constituting a position, if not precisely inconsistent with the in kind provision in the lease, at least one indicating a practical intention to abandon a claim to royalty gas in kind. In another Fifth Circuit case arising out of Texas,[45] the court construed the actions of the lessors in "neither request[ing] delivery of the royalty oil in kind nor tender[ing] any facilities for the taking in kind"[46] as conduct clearly inconsistent with an understanding that delivery was to be in kind. Attention was directed to the fact that it was customary in the industry for the lessee to market all of the oil to a field purchaser if other than the lessee. This is even more true with respect to gas.

The foregoing discussion illustrates a waiver theory which avoids the problem with estoppel, which requires some sort of detrimental reliance. The lessee has not changed his position with respect to the lessor's actions, but refusal to provide a means to take delivery in kind certainly suggests an intention to waive such right, which in the case of gas, should continue throughout the life of the contract absent an expression to the contrary within the lease. But estoppel may arise when, for example, the lessor executes a binding division order or one tied to the gas purchase contract.

Assuming an "in kind" royalty provision, the question then arises as to the method to be used by the lessee in accounting for the royalty. Either the current market value of the gas or the value as fixed by the conventional gas sales contract could be employed. Since the majority in *Vela* indicated that an in kind provision would have presented a different situation not necessarily controlled by market value, it can be argued that the lessee would utilize the value fixed by the gas sales contract.[47]

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44. *Id.* at 220.

45. Atwood v. Humble Oil & Ref. Co., 338 F.2d 502 (5th Cir. 1964), *cert. denied*, 381 U.S. 926 (1965).

46. *Id.* at 510.

47. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968). The court stated:

> It is clear that the parties knew how to and did provide for royalties payable in kind, based upon market price or market value, and based upon the proceeds derived by the lessee from the sale of gas. They might have agreed that the royalty on

CONCLUSION

An in kind gas royalty clause is not the only possible variation providing a basis upon which to distingiush *Vela* and any federal cases relying on it, but such a provision does appear in a number of leases, including all those on state owned lands over which there is a present controversy involving a number of large oil companies.[48] The majority in *Vela* relied upon the very atypical situations presented in *Huber* and *Foster*, both of which were mere diversity cases and hardly controlling precedent. The courts will not rewrite contracts fairly negotiated between equally situated parties, nor can they alter the terms of the lease which, as a result of *Vela*, leaves the lessee in a most unfortunate situation. As stated in *Foster*:

> The inability of [lessee] to make a gas sales contract with escalation provisions is beside the point. . . . The fact that its purchaser would not agree to pay the prevailing market price at the time of delivery does not destroy the lease obligation . . . . When it made the gas sales contract, [lessee] took the calculated risk of that contract producing royalties satisfactory to the lease terms. The fact that increases . . . have made the lease obligations financially burdensome is no defense.[49]

As the purchaser is obligated to pay only in accordance with the terms of the gas purchase contract, lessee is forced to account for any difference in the contract price and the market value. It appears hardly reasonable to suggest that the parties intended, by committing the gas at a specified price in order to comply with the lease obligations, that the lease may later convert from the benefit intended to an onerous burden, antithetical to the very purpose for which the lease was executed. A slightly varied royalty clause may offer the supreme court an opportunity to reconsider its opinion in *Vela*, now standing as the only strong precedent in Texas, and render a decision more in line with the above analysis as well as more in keeping with the practicalities of the gas industry as a whole.

> gas produced from a gas well would be a fractional part of the amount realized by the lessee from its sale. Instead of doing so, however, they stipulated in plain terms that the lessee would pay one-eighth of the market price at the well . . . .

Id. at 871.

48. *See Thrust and Focus of Attorney General's Office*, 37 TEX. B.J. 23, 26 (1974).

49. Foster v. Atlantic Ref. Co., 329 F.2d 485, 489 (5th Cir. 1964).