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Determination of Fair Market Value for Ad Valorem Tax Purposes of a Gas Lease Burdened with a Long-Term Sales Contract.

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DETERMINATION OF FAIR MARKET VALUE FOR AD VALOREM TAX PURPOSES OF A GAS LEASE BURDENED WITH A LONG-TERM SALES CONTRACT

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The marketing of natural gas can occur only through intricate pipeline systems.[1] Due to the tremendous expense of constructing, financing, and maintaining pipeline networks, assurance of a continuing and lasting commitment of gas is therefore necessary.[2] In order to acquire this necessary assurance, the gas industry requires that gas be dedicated to long-term sales contracts.[3] As a result of the lengthy commitments required, there is only minimal free exchange of the commodity on the open market.[4] This limited free exchange of gas on the open market, combined with dramatic increases in market value of gas, has produced an anomalous result. Many of the older, long-term contracts still in effect contain gas sales prices that are substantially below the selling price of gas more recently committed to sales contracts.[5] This frequent disparity between the contract price[6] and the current market value of gas has given rise to a problem in the area of ad valorem taxation.

The basis for ad valorem tax valuation of natural gas is fair market value, an essential element of which is the property's income producing potential. Yet the disparity between the contract price and the current market value of gas has created a problem in determining the income potential of property as an element of fair market value. The question is whether the long-term gas sales contract price or the price that could be obtained in a currently renegotiated sales contract is the proper figure to be considered in assessing the property's income producing potential.[7] The

1. Comment, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 Texas L. Rev. 641, 641-42 (1947); 46 Texas L. Rev. 291, 293 (1967); *see* Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964).

2. Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964)(pipelines require committed supply of gas); 23 Sw. L.J. 388, 389 (1969); 46 Texas L. Rev. 291, 293 (1967).

3. Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964); 23 Sw. L.J. 388, 389 (1969).

4. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 488-89 (5th Cir. 1964); Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198 (5th Cir.), *cert. denied*, 329 U.S. 714 (1946); 46 Texas L. Rev. 291, 293 (1967).

5. *See, e.g.*, Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 868 (Tex. 1968); Butler v. Exxon Corp., 559 S.W.2d 410, 412 (Tex. Civ. App.—El Paso 1977, no writ)(1000% increase between 1970 and 1975).

6. Since regulatory agencies often dictate the maximum price that may be charged for gas, the phrase gas sales contract price, as used in this comment, means the price actually received for the sale of gas.

7. This approach assumes that either the gas sales contract price or the price that could be obtained in a currently renegotiated contract should be conclusive in the determination

income approach to value, which has been recognized in Texas, assumes that a prospective investor in property is primarily concerned with its revenue potential.[8] Assessment under the income approach requires that an accurate estimate of future proceeds be multiplied by a capitalization rate which is determined by an assessor.[9] This assessment hinges upon various circumstances at the time of the original contract's negotiation. Evaluation of these circumstances is difficult, however, because of the absence of either judicial or legislative guidance. There are very few, if any, set standards from which such a determination can be made. No Texas court has addressed the issue of whether the gas sales contract price or the current market price of gas not bound by such a contract should be used in computing fair market value of a mineral estate for ad valorem taxation purposes.

AUTHORITY TO LEVY AD VALOREM TAXES

Generally, the State of Texas has the authority to tax all property, either real or personal, that is within its boundaries.[10] The Texas Constitution specifically authorizes counties, subject to certain restrictions, to levy ad valorem taxes on all property within their confines.[11] Article VIII, section 1 of the Texas Constitution provides that "[a]ll property . . . shall be taxed in proportion to its value, which shall be ascertained as may be provided by law."[12] Fair market value has been defined by statute to mean the price which property at its present situs at the time of assessment would bring at a voluntary and private sale, expressed in terms of the fair cash market value.[13]

Numerous sources have advocated ad valorem taxation based upon fair market value. Many Texas courts have determined valuation for ad valo-

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of potential income as a factor in the calculation of fair market value. If the contract price is utilized it should be used only to the extent of the contract's duration.

8. Polk County v. Tenneco, Inc., 554 S.W.2d 918, 921 (Tex. 1977)(adopting capitalization of income method for assessing value of pipeline). The comparative sales method of valuation is sometimes utilized. Its applicability, however, is somewhat limited due to the extensive number of variables involved in a gas field.

9. *See* Tenneco, Inc. v. Polk County, 546 S.W.2d 63, 65 (Tex. Civ. App.—Beaumont 1976), *rev'd on other grounds*, 554 S.W.2d 918 (Tex. 1977).

10. Hall v. Miller, 102 Tex. 289, 293, 115 S.W. 1168, 1170 (1909)(all property with permanent situs in state is taxable); TEX. CONST. art. VIII, § 1 ("All property in this State . . . shall be taxed in proportion to its value . . . ."); TEX. REV. CIV. STAT. ANN. art. 7145 (Vernon 1960)("All property, real, personal . . . is subject to taxation . . . .").

11. TEX. CONST. art. VIII, § 1-a (counties, rather than the state, have right to levy ad valorem taxes).

12. TEX. CONST. art. VIII, § 1.

13. TEX. REV. CIV. STAT. ANN. art. 7149 (Vernon 1960). The terms "market value," "fair market value," "cash market value" and "fair cash market value" are all interchangeable. Hutchings v. State, 466 S.W.2d 584, 585 (Tex. Crim. App. 1971); McInnis v. Brown County Water Improvement Dist. No. 1, 41 S.W.2d 741, 746 (Tex. Civ. App.—Austin 1931, writ ref'd).

rem tax purposes to be based on the "reasonable cash market value" of property.[14] Additionally, article 7174, which provides for valuation of property for ad valorem taxation, states that real property "shall be valued at its true and full value in money . . . ."[15] It is apparent that the state as well as its political subdivisions has the authority to levy property taxes in accordance with the fair market value of each piece of property.

Fair Market Value Considerations

Lessors and lessees of mineral estates are taxed on their separate estates.[16] The lessor's income is based upon his lease agreement with the lessee.[17] The lessee's income is based upon his sales contract with a gas purchaser. It is apparent, therefore, that the income producing potential of each estate is affected differently by various considerations.

Distinguished from Surface Estates

In the valuation of surface estates the courts have uniformly held the definition of fair market value for ad valorem tax purposes to be the price a willing buyer would pay a willing seller for a particular piece of property, neither being under a necessity to buy or sell.[18] Various factors which influence the net worth of land are proper considerations in arriving at its value.[19] A long-term lease of property that could be leased for a greater sum if renegotiation were possible may affect the net worth of that property.[20] Several courts have felt that if the lease represented a fair value when made, and was made in good faith, it must be given substantial influence

14. *See, e.g.*, State v. Whittenburg, 153 Tex. 205, 209, 265 S.W.2d 569, 572 (1954); Rowland v. City of Tyler, 5 S.W.2d 756, 760 (Tex. Comm'n App. 1928, judgmt adopted). Reasonable cash market value is a proper element in determining fair market value. *Id.* at 760; Harlingen Independent School Dist. v. Dunlap, 146 S.W.2d 235, 237 (Tex. Civ. App.—San Antonio 1940, writ ref'd).

15. Tex. Rev. Civ. Stat. Ann. art. 7174(a) (Vernon Supp. 1978).

16. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 175, 254 S.W. 290, 296 (1923); Extraction Resources, Inc. v. Freeman, 555 S.W.2d 156, 159 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.); *see* Big Lake Oil Co. v. Reagan County, 217 S.W.2d 171, 173 (Tex. Civ. App.—El Paso 1948, writ ref'd).

17. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 489 (5th Cir. 1964); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968).

18. West Texas Hotel Co. v. City of El Paso, 83 S.W.2d 772, 775-76 (Tex.Civ. App.—El Paso 1935, writ dism'd); *see* Tenneco, Inc. v. Polk County, 546 S.W.2d 63, 65 (Tex. Civ. App.—Beaumont 1976), *rev'd on other grounds*, 554 S.W.2d 918 (Tex. 1977)(valuation of gas pipeline); *cf.* City of Austin v. Cannizzo, 153 Tex. 324, 331, 267 S.W.2d 808, 813 (1954)(condemnation proceeding).

19. *See* Lufkin Land & Lumber Co. v. Noble, 127 S.W. 1093, 1098 (Tex. Civ. App. 1910, writ ref'd); *accord*, Bensalem Township School Dist. v. County Comm'rs, 303 A.2d 258, 262 (Pa. Commw. Ct. 1973)(zoning regulation).

20. *See* Caroldee Realty Corp. v. Board of Assessors, 340 N.Y.S.2d 774, 780 (Sup. Ct. 1972)(leases entered in exercise of good judgment affect value).

in the determination of fair market value.[21]

Several states, however, have ignored the lease income approach in determining the fair market value of surface realty for property tax purposes.[22] Likewise, if bad judgment was used in negotiation, resulting in an uneconomical lease contract, or exigent circumstances caused a contract to be entered into at less than a fair price, evidence to this effect would warrant an assessment based upon greater than contract value.[23] Allowing this assessment to be based upon the current value rather than contract value appears to be reasonable if the contract did not truly reflect market value either at the time of negotiation or at the time of assessment.[24] At least one state's highest court reached this result, reasoning that it is not the duty of the county to sacrifice its tax revenue simply because a particular surface estate is burdened with a long-term uneconomical lease.[25]

There is a fundamental difference, however, between the method of assessing a surface estate lessee's interest and a mineral lessee's interest. Unquestionably, the legislature has the power to authorize taxation of a lessee's interest in a surface estate;[26] however, such action generally has not been pursued.[27] Article 7174[28] speaks of "[t]axable leasehold estates." Nevertheless, this article has been interpreted to authorize taxation to the lessee only of surface interests in public lands.[29] Thus, the ad valorem tax on surface estates is levied on the owner of the land as a whole, and all conceivable interests into which the property could be severed are included as one unit.[30] Long-term lease rental which could be renegotiated at a

21. Caroldee Realty Corp. v. Board of Assessors, 340 N.Y.S.2d 774, 780 (Sup. Ct. 1972); *see* F.W. Woolworth Co. v. Commission of Taxation and Assessment, 272 N.Y.S.2d 257, 260, 261 (App. Div. 1966)(value of property determined by capitalizing fair rental value); People *ex rel.* Gale v. Tax Comm'n, 233 N.Y.S.2d 501, 506 (App. Div. 1962).

22. *See* Donovan v. City of Haverhill, 141 N.E. 564, 565 (Mass. 1923); Swan Lake Moulding Co. v. Department of Revenue, 478 P.2d 393, 395 (Or. 1970)(value of lease to lessor's interest is ignored); *cf.* Demoulas v. Town of Salem, 367 A.2d 588, 593 (N.H. 1976)(long-term lease not considered when result of poor management).

23. *See* Demoulas v. Town of Salem, 367 A.2d 588, 593 (N.H. 1976).

24. *See* Yadko, Inc. v. Yankton County, 237 N.W.2d 665, 669 (S.D. 1975) (artificial restraint of income-potential not to be considered).

25. *Id.* at 669.

26. 54 TEX. JUR. 2d *Taxation* § 55 (1964); *see* TEX. REV. CIV. STAT. ANN. art. 7145 (Vernon 1960)(authorizing taxation of all property).

27. Daugherty v. Thompson, 71 Tex. 192, 199, 9 S.W. 99, 101 (1888) (lessee not liable for property taxes unless law expressly provides); Irving Independent School Dist. v. Delta Airlines, Inc., 534 S.W.2d 365, 368 (Tex. Civ. App.—Texarkana 1976, writ ref'd n.r.e.). *See generally* 54 TEX. JUR. 2d *Taxation* § 55 (1964). Leasehold interests in public lands are the exception and are generally subject to taxation.

28. TEX. REV. CIV. STAT. ANN. art. 7174 (Vernon Supp. 1978).

29. *See* Daugherty v. Thompson, 71 Tex. 192, 199, 9 S.W. 99, 101 (1888)(lessee of city water works taxable because public lands); TEX. REV. CIV. STAT. ANN. art. 7173 (Vernon Supp. 1978). *See generally* 54 TEX. JUR. 2d *Taxation* § 55 (1964).

30. Daugherty v. Thompson, 71 Tex. 192, 199, 9 S.W. 99, 101 (1888) (general rule that owner of property taxed on entire value); *accord,* Donovan v. City of Haverhill, 141 N.E. 564,

higher price reduces the lessor's putative income; therefore, the value of the property to the lessor is reduced because of the current lease.[31] Likewise, the lease is more valuable to the lessee at the present rent than it would be at a renegotiated higher rent. Since the property tax statutes make no stipulation for separate assessment of a surface estate to the lessee, the increased value of the lessee's interest should be borne by the lessor, who is taxed on the entire value of the surface estate.[32]

Conversely, the lessor[33] and lessee[34] of a mineral estate are taxed only upon the value of their respective interests.[35] If the rationale that gives substantial influence to a surface lease that represented a fair rental price when made is followed, it seems that a gas sales contract price that reflected a fair price when executed should also be utilized in the determination of fair market value. Since mineral leasehold interests are taxed to the individual parties, the theory that disregards a surface lease contract because the property is taxed as one unit should be inapplicable. The value of the lease to the leasehold parties should be determined in accordance with the amount of income that each party has a right to receive since fair

565 (Mass. 1923); People *ex rel.* Gale v. Tax Comm'n, 233 N.Y.S.2d 501, 504 (App. Div. 1962); Swan Lake Moulding Co. v. Department of Revenue, 478 P.2d 393, 395 (Or. 1970)(Oregon statutes make no provision for separate assessment to lessee).

31. *See* Swan Lake Moulding Co. v. Department of Revenue, 478 P.2d 393, 395-96 (Or. 1970).

32. People *ex rel.* Gale v. Tax Comm'n, 233 N.Y.S.2d 501, 505 (App. Div. 1962); Swan Lake Moulding Co. v. Department of Revenue, 478 P.2d 393, 395-96 (Or. 1970).

33. The lessor in a gas lease is usually the surface owner. *See, e.g.,* Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 168, 254 S.W. 290, 292 (1923); Big Lake Oil Co. v. Reagan County, 217 S.W.2d 171, 173 (Tex. Civ. App.—El Paso 1948, writ ref'd); Ferguson v. Steen, 293 S.W. 318, 320 (Tex. Civ. App.—Waco 1927, no writ). All minerals included in the lease pass to the lessee at the time the lease is executed. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 168, 254 S.W. 290, 292 (1923)(grantors divested of their right to possess). The lessor retains a possibility of reverter in the mineral fee since the lessee's estate is a determinable one. *Id.* at 174, 254 S.W. at 295 (possibility of reacquiring fee simple title).

34. It is well settled in Texas that an oil and gas lease creates a real property interest in the lessee which is subject to separate taxation. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 175, 254 S.W. 290, 296 (1923); Extraction Resources, Inc. v. Freeman, 555 S.W.2d 156, 159 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.); *see* Big Lake Oil Co. v. Reagan County, 217 S.W.2d 171, 173 (Tex. Civ. App.—El Paso 1948, writ ref'd). The nature of the lessee's estate in a gas lease is determined by the terms of the instrument itself. *See* Kidd v. Hickey, 237 S.W.2d 389, 392 (Tex. Civ. App.—El Paso 1950, writ ref'd n.r.e.); Curry v. Texas Co., 18 S.W.2d 256, 258 (Tex. Civ. App.—Eastland 1929, writ dism'd). The usual gas lease is a transfer of real property which vests the lessee with title to gas in place. Gulf Oil Corp. v. Marathon Oil Co., 137 Tex. 59, 82, 152 S.W.2d 711, 724 (1941). A lease, during its duration, vests the ownership of the oil and gas in the lessee as effectively as a grant under a mineral deed. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 172, 254 S.W. 290, 294 (1923).

35. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 175, 254 S.W. 290, 296 (1923); *see* Extraction Resources, Inc. v. Freeman, 555 S.W.2d 156, 159 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.); State v. Downman, 134 S.W. 787, 793 (Tex. Civ. App. 1911, writ ref'd).

market value is determined partially from a property's income producing potential. Consequently, fair market value to the lessee should be determined on the basis of the income receivable under the gas sales contract, provided it represented a fair price when negotiated. Likewise, the lessor's assessment should be based upon the income actually obtainable under the oil and gas lease.

The Effect of Royalty Interest Payments

A useful tool in the determination of the proper method of valuing the leasehold estates in a gas lease is the interpretation of fair market value of royalty payments[36] to the lessor under an oil and gas lease. The Texas Supreme Court has defined the term "market value" in a gas lease contract, for royalty payment purposes, to mean the current selling price of gas in the area without regard to the long-term gas sales contract price.[37] Even though royalty payments based upon an amount larger than actual income may become overly burdensome to the lessee, the contractual obligation between the lessee and the lessor should remain unaffected.[38] The court's rationale seems to be based upon the fact that the lessor did not consent to acceptance of royalties based on the long-term sales contract price; consequently, market price is determined from the express provisions of the original lease agreement.[39] Thus, it appears that a determination of fair market value for royalty payments to the lessor involves an interpretation of the specific contractual obligation to pay royalty in the lease, specifically, whether the lease is of a proceeds or market value type.[40]

36. Royalty is a share of the production which the lessor reserves as compensation for allowing the lessee to enter his land and deplete his minerals. *See* State Nat'l Bank v. Morgan, 135 Tex. 509, 516-17, 143 S.W.2d 757, 761 (1940); Wagner Supply Co. v. Bateman, 118 Tex. 498, 506, 18 S.W.2d 1052, 1055 (1929).

37. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968)("one-eighth of the market price at the wells"); *accord,* Foster v. Atlantic Ref. Co., 329 F.2d 485, 490 (5th Cir. 1964)(lease called for one-eighth of market price).

Leases with royalties to be computed on "market value" or "market price" of gas at the wellhead should not take the contract price into consideration. Leases that provide for royalty to be computed as a percentage of "proceeds" or "amount realized" should utilize the gas sales contract price. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968)(parties may agree to royalties based upon amount actually received by the lessee); Butler v. Exxon Corp., 559 S.W.2d 410, 415 (Tex. Civ. App.—El Paso 1977, no writ).

38. Foster v. Atlantic Ref. Co., 329 F.2d 485, 489-90 (5th Cir. 1964)(fact that purchaser refused to pay current market value of gas is immaterial); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968).

39. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 489 (5th Cir. 1964); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968).

40. The income actually obtainable by the lessor depends almost entirely upon the royalty provision in his lease. The Texas Supreme Court appears to believe that royalties computed on "market price" or "market value" are not the same as royalties computed on "proceeds" or "amounts realized." Royalties based on market price should be calculated according to the prevailing fair market value of gas in the area at the time of sale. Conversely,

In an assessment of mineral property, however, no royalty obligation between the lessee and the taxing agency is involved. Since there is no such contractual obligation, the assessor must tax the lessee's interest at its true market value in its present condition. The gas sales contract directly affects the income producing potential of the gas lease, which is an element in the determination of fair market value. Thus, in computing the fair market value of the lessee's interest, the gas sales contract price should be employed, so long as it was reasonable at the time of negotiation. In contrast, the market value of the lessor's interest should be determined without regard to the long-term sales contract since the lessor is entitled to royalty based upon a percentage of the current selling price in the area without regard to the long-term gas sales contract price, unless the lease calls for royalties based upon "proceeds." This is entirely logical because a buyer would consider only the income actually obtainable in determining what he would be willing to pay for the lessor's interest.

Willing Buyer's Considerations

In determining the fair market value of the lessee's mineral interest, the most persuasive argument for utilizing the actual gas sales contract price rather than a higher price at which the contract could be renegotiated is found within the definition of fair market value itself. Fair market value is the price a willing buyer with no necessity to buy would pay a willing seller under no necessity to sell.[41] Since the ad valorem tax is levied upon fair market value, the factors that a taxing entity must consider in its determination of a property's worth are basically the same factors which a willing buyer must consider in order to determine a fair purchase price.[42] Generally, a willing buyer as well as a tax assessor should compute the value of a piece of property in its present condition.[43] In an effort to determine the present condition of a particular piece of property, a prudent investor would familiarize himself with its income producing background in order to assure himself of a satisfactory return on his investment. Fur-

royalty calculations based upon proceeds or amount realized will allow payments to be based on the gas sales contract price. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968).

41. Tenneco, Inc. v. Polk County, 546 S.W.2d 63, 65 (Tex. Civ. App.—Beaumont 1976)(quoting City of Austin v. Cannizzo, 153 Tex. 324, 334, 267 S.W.2d 808, 815 (1954)), *rev'd on other grounds*, 554 S.W. 2d 918 (1977).

42. *See* West Texas Hotel Co. v. City of El Paso, 83 S.W.2d 772, 776-77 (Tex. Civ. App.—El Paso 1935, writ dism'd); *accord*, Alvin v. Johnson, 63 N.W.2d 22, 25 (Minn. 1954) (assessor must consider that realty is burdened with easement); Bensalem Township School Dist. v. County Comm'rs, 303 A.2d 258, 262 (Pa. Commw. Ct. 1973).

43. DeLuz Homes, Inc. v. County of San Diego, 290 P.2d 544, 554 (Cal. 1955)(en banc)("desirability translated into money amounts"); Xerox Corp. v. County of Orange, 136 Cal. Rptr. 583, 587 (Ct. App. 1977); *see* Bensalem Township School Dist. v. County Comm'rs, 303 A.2d 258, 262 (Pa. Commw. Ct. 1973).

thermore, it is essential that in any true determination of fair market value the "current yield as well as income potential in the foreseeable future" be considered.[44] It logically follows, therefore, that in valuing property for ad valorem taxation purposes, an assessor should consider the price received by the lessee under an existing sales contract as well as the price to be received for the remainder of the contract, to the extent that income is an element in valuation.

Effect of Interstate Ceilings

The definition of fair market value for royalty payment purposes of gas sold in the interstate market is a viable guideline towards a proper method of valuing the separate leasehold estates in a gas lease. The price at which gas may be sold in the interstate market is subject to Federal Power Commission rate ceilings.[45] In cases involving disputes of royalty payments due the lessor, courts have held that the lessor is entitled to royalty based upon the theoretical market price provided in the oil and gas lease, without reference to the regulated price the lessee actually receives, provided the royalty clause is not of a "proceeds" type.[46] Here again, these decisions appear to be based upon the contractual relations between each lessor and lessee.[47] There is no contractual relation whatsoever between the leasehold parties and the taxing entity; therefore, the lessor and lessee should be required to pay ad valorem taxes based only upon the actual fair market value of their respective interests. Since income potential is an important element to be considered in a true determination of fair market value, it is necessary to determine the income actually obtainable by each leasehold party. Pursuing the court's reasoning in the royalty payment cases dealing with interstate gas sales, the lessor having a right to receive income based on the theoretical value of gas without reference to the federal price regulation, should be taxed on that income.[48] This argument appears to be even stronger if one recalls that the federal regulation of gas prices is imposed

44. Caroldee Realty Corp. v. Board of Assessors, 340 N.Y.S.2d 774, 780 (Sup. Ct. 1972); *see* Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944)(investor needs assurance of enough income to cover operating expenses, capital costs, and risk of investment).

45. Kingery v. Continental Oil Co., 434 F. Supp. 349, 354 (W.D. Tex. 1977). The Federal Power Commission derives its authority to regulate gas prices from the Natural Gas Act of 1938, 15 U.S.C. § 717 (1970).

46. *See* Kingery v. Continental Oil Co., 434 F. Supp. 349, 355 (W.D. Tex. 1977); Lightcap v. Mobil Oil Corp., 562 P.2d 1, 8 (Kan. 1977). If the lessee promised to pay market value at the time of sale, such market price will be ascertained at the date of delivery. Kingery v. Continental Oil Co., 434 F. Supp. 349, 354 (W.D. Tex. 1977).

47. *See* Lightcap v. Mobil Oil Corp., 562 P.2d 1, 8 (Kan. 1977).

48. A proper computation of fair market value requires a careful analysis of the lease contract to determine if the lessee has promised to pay market value at the time of sale. The time of sale is at the time of delivery and not at the time of executing the contract. Kingery v. Continental Oil Co., 434 F. Supp. 349, 354 (W.D. Tex. 1977).

without the consent of the lessee. The lessee should also be taxed upon the income actually receivable, that being the price stipulated in his gas sales contract.

Analogy to Gas Production Tax

The meaning of fair market value for production tax purposes is a valuable source from which an analogy may be drawn. A production tax is levied on all producers of gas[49] and is based on market value.[50] Market value for production tax purposes was originally defined by statute to include almost anything of value received for the sale of gas.[51] The Texas Supreme Court, in an effort to determine and uphold the legislature's intent, found market value for production tax purposes to be the actual income received by producers under their gas sales contracts, despite the fact that gas sales under recently negotiated contracts in the same area brought a higher price.[52] The original statute which defined market value for production tax purposes has been repealed and replaced in part by article 3.01(1) of the taxation statutes, which levies the production tax on a percentage of fair market value of the gas.[53] Article 3.02(1) of the codified taxation statutes, which defines market value for production tax purposes, provides that market value is the value at the wellhead, but that when gas is sold for cash only, the tax is to be based on the "producer's gross cash receipts."[54] In adopting the Texas Supreme Court decision that was decided under the old statute, one court has held that gross cash receipts means actual income.[55]

Due to the specific statutory definition of fair market value for production tax purposes, courts have noted that such characterization is not necessarily its ordinary legal meaning.[56] In *Calvert v. Union Producing*

49. TEX. TAX.-GEN. ANN. art. 3.04(1)(Vernon 1969) defines producer for production tax purposes as

> any person owning, controlling, managing, or leasing any gas well and/or any person who produces in any manner any gas by taking it from the earth or waters in this State, and shall include any person owning any royalty or other interest in any gas or its value whether produced by him, or by some other person on his behalf, either by lease, contract, or otherwise.

50. *See* TEX. TAX.-GEN. ANN. art. 3.01(1) (Vernon 1969).

51. 1959 Tex. Laws, 3d Spec. Sess., ch. 1, at 195. This act was codified into the "Taxation General."

52. W.R. Davis, Inc. v. State, 142 Tex. 637, 643-44, 180 S.W.2d 429, 432 (1944). The court held that value should be determined by the sales price so long as made in good faith. *Id.* at 644, 180 S.W.2d at 432.

53. TEX. TAX.-GEN. ANN. art. 3.01(1) (Vernon 1969).

54. TEX. TAX.-GEN. ANN. art. 3.02(1)(Vernon 1969).

55. Calvert v. Union Producing Co., 402 S.W.2d 221, 225 (Tex. Civ. App.—Austin 1966, writ ref'd n.r.e.).

56. W.R. Davis, Inc. v. State, 142 Tex. 637, 643, 180 S.W.2d 429, 432 (1944); Calvert v. Union Producing Co., 402 S.W.2d 221, 226 (Tex. Civ. App.—Austin 1966, writ ref'd n.r.e.).

Co.[57] the court appears to accept the producer's contention that market value for other oil and gas lease purposes has a different meaning than for production tax purposes.[58] *Foster v. Atlantic Refining Co.*[59] was cited as authority for the meaning of fair market value for gas lease purposes.[60] *Foster,* however, determined market value for royalty payment purposes to be based on present market value rather than contract price when the lease provides for payment to be calculated on market price of gas at the wellhead,[61] but made no attempt to define market value for all matters involving an oil and gas lease. Although the meaning of fair market value for production tax and ad valorem tax purposes is not necessarily equivalent, the reasoning underlying the decision that production tax fair market value means actual income may be enlightening.

Under the terms of the gas production tax statute, a purchaser is required to deduct the amount of production tax for which the producer is liable from the purchase price and hold it in trust for the state.[62] It would be unusual indeed for the purchaser to make a deduction for tax purposes based on one price and remit the production tax based on another price.[63] In essence, the amount the purchaser is allowed to deduct from the purchase price is also the amount he should be required to remit in taxes.[64] It would seem unjust for the lessee in a gas lease to be bound to the price received under his long-term gas sales contract but to have the market value from which his property taxes are based computed on another price without regard to the existing contract. Similarly, the lessor's tax liability should be based upon the price he is entitled to receive under the lease.

POLICY ARGUMENT

One might contend that the state should not be penalized because of the mineral owner's bad judgment or because of unpredictable market forces.[65] The taxing entity had absolutely no voice in the negotiation of the gas sales contract, and surely it did not bargain for sales at a price lower than the current market value. To tax the lessee at any rate lower than the property's total current worth would reward the lessee with a windfall, even

57. 402 S.W.2d 221 (Tex. Civ. App.—Austin 1966, writ ref'd n.r.e.).

58. *Id.* at 226.

59. 329 F.2d 485 (5th Cir. 1964).

60. Calvert v. Union Producing Co., 402 S.W.2d 221, 226 (Tex. Civ. App.—Austin 1966, writ ref'd n.r.e.).

61. Foster v. Atlantic Ref. Co., 329 F.2d 485, 489-90 (5th Cir. 1964)(interpretation of contract providing for market price "prevailing . . . when run").

62. TEX. TAX.-GEN. ANN. art. 3.03(2) (Vernon 1969).

63. W.R. Davis, Inc. v. State, 142 Tex. 637, 643, 180 S.W.2d 429, 432 (1944)(interpretation of original statute defining market value for production tax purposes).

64. *See id.* at 643, 180 S.W.2d at 432.

65. *Cf.* Yadko, Inc. v. Yankton County, 237 N.W.2d 665, 669 (S.D. 1975)(20 year lease of manufacturing plant and land).

though the windfall may be only an increase of profits, which are already minimal because of the lessee's poor judgment.

The problem can be stated as where the burden should fall: reduced profits to the lessee, or reduced tax revenue to the public. Implicit in this argument could be the assumption that the lessee used poor judgment by encumbering his property with a gas sales contract that provides for less than optimum prices. It is vitally important to realize, however, that in the recent past gas has taken unprecedented escalations in value and a producer had no reason to expect a sharp increase in value within the life of his contract.[66] It also may be assumed, in the absence of evidence to the contrary, that the lessee acted in the manner most beneficial to his own pecuniary interest.[67] In securing a lasting market for his gas which was worth very little at the time of contracting for its sale, the lessee may have been acting reasonably under the foreseeable circumstances.

Since the relatively recent dramatic increase in the value of gas, various types of escalation clauses have become a standard inclusion in a gas sales contract.[68] One of the most popular of such price adjustment provisions is the "favored nations" clause, which provides for an increase in the contract sales price equal to any greater price contracted to be paid by the buyer[69] in the same area.[70] Any lessee entering into a gas sales contract since the definite upward trend in gas value would probably be exercising poor judgment if such an escalation clause was not incorporated into the agreement. Consequently, a determination of whether a lessee used good or bad judgment could depend largely upon the time at which the gas sales contract was negotiated.

It seems logical that a gas sales contract negotiated without a proper escalation clause, at a time in which the lessee should have been aware of a possible future increase in gas value, should not be conclusive as the income factor in the assessment of fair market value for property tax purposes. However, a similar contract entered into before the lessee was put on notice of a potential increase in gas prices could be a determinative element in the assessment of market value for property tax purposes.

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66. *See* Southland Royalty Co. v. Federal Power Comm'n, 543 F.2d 1134, 1135 (5th Cir. 1976), *cert. granted,* ___ U.S. ___, 97 S. Ct. 2970, 53 L. Ed. 2d 1091 (1977).

67. *See* People *ex rel.* Gale v. Tax Comm'n, 233 N.Y.S.2d 501, 507 (App. Div. 1962).

68. *See* 4 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 726, at 748.4-.5 (1962)(escalation clauses included because of federal regulation).

69. The buyer referred to is the purchaser of gas under the long-term sales contract.

70. *See* 4 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 726, at 748.4-750 (1962). The favored nations clause can be divided into two general categories. The first category is the "two party favored nations clause" whereby the buyer promises to pay the seller an amount equal to any higher price he contracts to another seller in the same area. The second general category is the "third party favored nations clause." This escalation clause forces the buyer to pay any greater price contracted to be paid by *any* buyer in the same field or area. *Id.* at 748.5-750.

CONCLUSION

A taxing entity may readily contend that it should not be required to sacrifice its tax revenue simply because an oil and gas lessee negotiated a long-term gas sales contract at a price below the current selling price of gas. An assessor is required, however, to assess property at its fair market value in its present condition[71] at the time of assessment.[72] Fair market value is based upon what a willing buyer would pay for a piece of property. A prospective buyer would consider the effect of a long-term gas sales contract when purchasing a lessee's interest in a gas lease. Consequently, fair market value for ad valorem tax valuation of the lessee's interest must also reflect the existence of a long-term gas sales contract for the duration of the contract. To disregard contract price would, in essence, negate the statutory requirement that ad valorem taxes be based upon fair market value. Contract price should be the basis for computing the income potential element of the assessment of the lessee's interest only if it was negotiated in the exercise of reasonable judgment and represented a fair price when executed. Therefore, the assessment of the fair market value of the lessee's interest in an oil and gas lease should be based on the income derived from the gas sales contract, to the extent that income is an element. Similarly, unless the two prices are the same, the assessment of the lessor's interest in an oil and gas lease should be based upon the income obtainable under the lease agreement rather than upon the sales contract price. Of course if the two prices are the same, the lessor should be taxed upon the existing sales contract price.

71. DeLuz Homes, Inc. v. County of San Diego, 290 P.2d 544, 554 (Cal. 1955)(en banc); Xerox Corp. v. County of Orange, 136 Cal. Rptr. 583, 587 (Ct. App. 1977).

72. *See* TEX. REV. CIV. STAT. ANN. art. 7149 (Vernon 1960).