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Vela: Legacy of Conflict over Determination of Market Value for Royalties on Intrastate and Interstate Gas and Continued Controversy with the Natural Gas Policy Act of 1978.

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COMMENTS

VELA: LEGACY OF CONFLICT OVER DETERMINATION OF MARKET VALUE FOR ROYALTIES ON INTRASTATE AND INTERSTATE GAS AND CONTINUED CONTROVERSY WITH THE NATURAL GAS POLICY ACT OF 1978.

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For many years royalty owners have brought suit against producers of natural gas for increased royalty payments based on increasing market value.[1] Both the Court of Appeals for the Fifth Circuit and the Texas Supreme Court have allowed the royalty owners' right of recovery against the producers,[2] and have held the producers liable for increased royalty payments regardless of the burden.[3] Despite these rulings, it remains unclear exactly how to determine market price or market value.[4] Neither the Fifth Circuit

1. *See, e.g.*, Sartor v. Arkansas Natural Gas Corp., 321 U.S. 620, 622 (1944); Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 86 (5th Cir. 1966); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 868 (Tex. 1968). A royalty is the share of production received by the royalty owner as compensation for allowing the producer to deplete his minerals. Usually, the royalty is based on a fractional amount of the production, normally 1/8th or 1/16th. The royalty payment is therefore determined by the amount of production. *See* J.M. Huber Corp. v. Denman, 367 F.2d 104, 115 (5th Cir. 1966); Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, 20 ROCKY MTN. MIN. L. INST. 163, 172 (1975).

2. *See, e.g.*, Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 103 (5th Cir. 1966); Foster v. Atlantic Ref. Co., 329 F.2d 485, 487 (5th Cir. 1964); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 877-78 (Tex. 1968). *Contra*, Pierce v. Texas Pac. Oil Co., 547 F.2d 519, 521 (10th Cir. 1976) (contract price equals market price).

3. *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, 868 (Tex. 1968). In Texas a four-year statute of limitations applies to actions for recovery of royalty payments. *See* Kingery v. Continental Oil Co., 434 F. Supp. 349, 356 (W.D. Tex. 1977), *appeal docketed*, No. 78-1015 (5th Cir. Jan. 4, 1978); Humble Oil & Ref. Co. v. Fantham, 568 S.W.2d 239, 244 (Tex. Civ. App.—Galveston 1954, writ dism'd).

4. Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 832 (Tex. Civ. App.—Beaumont 1978, no writ) (intrastate). There are three main types of gas royalty clauses. First, a "proceeds" royalty clause provides for payment of royalty based on the price the producer receives from the original purchaser. Second, the "market price" royalty clause fixes the royalty payment based on the market price at the well. Third, the "market value" clause uses the market value as the basis for the royalty. A fourth type of royalty clause, an "in-kind" royalty provision, is rarely found in royalty clauses for natural gas and is more common in oil royalties. With *Vela,* however, some producers have switched to an "in-kind" provision

nor the supreme court has established specific guidelines for the determination of market value,[5] and the lower courts are in conflict in attempting to derive a market value standard.[6] The problem of market value computation concerns both the intrastate and interstate gas markets[7] and, furthermore, all natural gas sold subject to the Natural Gas Policy Act of 1978.[8]

BACKGROUND

Natural gas, often discovered in conjunction with oil production, was considered a waste product in the early days of the gas industry and was flared at the well.[9] After the Second World War, however, as former oil pipelines became dormant, it became feasible to transport large quantities of gas out of the local fields and regions and into the northeast and midwest sections of the country.[10] More extensions and new pipelines were laid, and eventually the complex and intricate pipeline system of today was established.[11]

To construct this new gas transmission system and to develop gas fields the producers and transmission firms required assurances of

providing for royalties to be paid by the fractional amount of the gas itself. *See* Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, 20 ROCKY MTN. MIN. L. INST. 163, 195-96 (1975); Kelly, *What Price, Gas?*, 7 ST. MARY'S L.J. 333, 344 (1975). In reality there is no difference between market price and market value. *See* J.M. Huber Corp. v. Denman, 367 F.2d 104, 107 n.5 (5th Cir. 1966); 3 H. WILLIAMS, OIL & GAS LAW § 650.2, at 648 (1977); Comment, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 TEXAS L. REV. 641, 652-53 (1947).

5. *See* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 89, 90 (5th Cir. 1966); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872 (Tex. 1968).

6. *See, e.g.*, Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ); Exxon Corp. v. Middleton, 571 S.W.2d 349, 362-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted); Butler v. Exxon Corp., 559 S.W.2d 410, 417 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

7. *See, e.g.*, Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978) (interstate gas), *appeal docketed*, No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978) (interstate); Exxon Corp. v. Middleton, 571 S.W.2d 349, 352 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted) (intrastate).

8. *See generally* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92 Stat. 3350 (1978).

9. Exxon Corp. v. Middleton, 571 S.W.2d 349, 352 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted). "From the air, West Texas was said to look as if campfires of all [sic] of the armies in the history of the world were burning below." *Id.* at 352. Gas not burned at the well was sold locally for community heating and lighting. *See id.* at 352.

10. *See id.* at 352.

11. *See id.* at 352; Comment, *Determination of Fair Market Value for Ad Valorem Tax Purposes of a Gas Lease Burdened With a Long-Term Sales Contract*, 10 ST. MARY'S L.J. 121, 121 (1978); Comment, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 TEXAS L. REV. 641, 641-42 (1947).

long term supplies and large amounts of natural gas.[12] Thus, from its inception the gas industry was subject to two economic realities: long term gas sales contracts and gas sales in huge quantities.[13] Until the 1970's, most gas was sold under long term contracts[14] that ordinarily committed the gas for a period of up to twenty years or the life of the lease.[15]

Under the typical long term contract the producer and the royalty owner entered into a lease agreement in which the producer was required to pay a royalty based on the amount of gas produced and according to the terms of the lease.[16] Older oil and gas leases used forms that provided for royalty payments based on the market value of the gas.[17] Largely ignoring the specific language of the lease, royalty owners were customarily compensated by payment based upon the proceeds from the sale of the gas and not according to the market value as provided for in the lease.[18]

During the 1960's contract prices for new gas began to exceed prices under contracts executed in the 1940's and 1950's.[19] Royalty owners, whose royalties were based on sales of interstate gas, brought actions to recover for underpayment of royalties alleging that royalties should be determined by current market value, which was usually higher than the sales price of the gas on which their

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12. *See* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966); Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964); Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 73 (Tex. Civ. App.—San Antonio 1966), *aff'd*, 429 S.W.2d 866 (Tex. 1968); Morris, *The Gas Royalty Clause—What Is Market Value?*, Sw. LEGAL FOUNDATION 25TH INST. ON OIL & GAS LAW & TAX. 63, 65 (1974).

13. *See* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966); Comment, *Determination of Fair Market Value for Ad Valorem Tax Purposes of a Gas Lease Burdened With a Long-Term Gas Sales Contract*, 10 ST. MARY'S L.J. 121, 121 (1978).

14. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 352 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

15. *See* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 89 (5th Cir. 1966).

16. *See* J.M. Huber Corp. v. Denman, 367 F.2d 104, 108 (5th Cir. 1966); Morris, *The Gas Royalty Clause—What Is Market Value?*, Sw. LEGAL FOUNDATION 25TH INST. ON OIL & GAS LAW & TAX. 63, 65-66 (1974).

17. *See* Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, 20 ROCKY MTN. MIN. L. INST. 163, 172 (1975).

18. Exxon Corp. v. Middleton, 571 S.W.2d 349, 353 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted) (various production charges deducted); Kelly, *What Price, Gas?*, 7 ST. MARY'S L.J. 333, 333 (1975) (at time of execution of contract, contract price approximate to market value).

19. *See* J.M. Huber Corp. v. Denman, 367 F.2d 104, 108-09 (5th Cir. 1966) (gas sold for $0.04 per Mcf in 1945, and for $0.11 per Mcf in 1961); Kelly, *What Price, Gas?*, 7 ST. MARY'S L.J. 333, 333 (1975) (gradual price rise).

royalty was based.[20] The complacency and custom that had existed in the Texas intrastate gas industry were dealt a severe blow by the Texas Supreme Court's decision in *Texas Oil & Gas Corp. v. Vela.*[21]

INTRASTATE MARKET

The Legacy of Vela

In *Vela* the Texas Supreme Court held that when the lease included a "market price" provision, the royalty owner was entitled to royalties based on the market price prevailing in the field rather than the sales price provided for in the gas sales contract.[22] The court reasoned the gas was not "being sold" at the time the gas sales contract was made; rather, a sale occurred with each delivery of gas to the purchaser.[23] Thus, the contract price for which the gas sold was not to be considered as the market price. Although specific guidelines for market value determination were not promulgated in *Vela,* the court held market price is to be determined by sales of gas "comparable in time, quality and availability to marketing outlets."[24]

Vela's Legacy: The Exxon Trilogy—A Conflict in Interpretation

Without any concrete market value formula, three Texas courts of civil appeals have ostensibly followed the *Vela* test in deciding

20. *See, e.g.,* J.M. Huber Corp. v. Denman, 367 F.2d 104, 108 (5th Cir. 1966); Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 86 (5th Cir. 1966); Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964). In *Foster* the royalty owner's royalty payment was based on a contract price of 10 cents per 1,000 cubic feet (Mcf), while the market price in the field at the time was 13 cents per Mcf in 1957 and 14 cents per Mcf in 1958-62. *Id.* at 488.

21. 429 S.W.2d 866 (Tex. 1968). *Vela* brought an end to the custom of computing royalties on the basis of the proceeds when the lease contained a market price or market value royalty clause. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 353 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

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

23. *See id.* at 871. The *Vela* lease provided for market value at the time of sale "while the same is being sold." *See* Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 72 (Tex. Civ. App.—San Antonio 1966), *aff'd,* 429 S.W.2d 866 (Tex. 1968). Relying on *Foster v. Atlantic Refining Co.,* the court in *Vela* held that merely because the payment of royalties on the basis of market value may prove financially burdensome was no excuse. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968); *see* Foster v. Atlantic Ref. Co., 329 F.2d 485, 489 (5th Cir. 1964).

24. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872-73 (Tex. 1968) (agreed with lower court that mathematical average of price not final answer, but no further market value test suggested).

royalty owner suits concerning market value.[25] Each of the courts has arrived at a different method for market value calculation.[26] In *Butler v. Exxon Corp.*[27] the El Paso Court of Civil Appeals held a market value royalty provision meant that royalties were to be paid based upon the market value at the time of delivery of gas to the purchaser.[28] Further, the court disapproved of a volume-weighted average as a basis for determining market value.[29]

In *Exxon Corp. v. Middleton*[30] the Houston Court of Civil Appeals for the Fourteenth District also applied *Vela* and held the contract price, circumstances of the contract's execution, and evidence of comparable sales, should all be considered to determine market value.[31] The court refused to allow Exxon's "field price" as the appropriate measure of market value.[32] This field price was ruled inappropriate because Exxon had used interstate gas sales in computing the price and the court held those sales did not meet the requirements of comparable sales according to the test set forth in *Vela.*[33]

25. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ); Exxon Corp. v. Middleton, 571 S.W.2d 349, 360, 363 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted); Butler v. Exxon Corp., 559 S.W.2d 410, 416 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

26. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ) (excluding pre-1973 gas prices, weighted average market price proper); Exxon Corp. v. Middleton, 571 S.W.2d 349, 362-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted) (enlarged *Vela* test approved; Exxon's weighted average held not market value because interstate sales included); Butler v. Exxon Corp., 559 S.W.2d 410, 413, 417 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (market value held to be average of three highest prices in field, not the weighted average price of all gas in the field).

27. 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

28. *See id.* at 416. The lease in question recited "market value at the well of all gas produced and saved from the premises." *Id.* at 416. The court followed *Vela* and interpreted market value to be calculated at the time of sale. Further, the time of sale was held to be the time of delivery of gas to the purchaser. Therefore, market value was determined at the time of delivery. *Id.* at 412, 416. Three other leases interpreted in *Butler* contained "proceeds" clauses in addition to a market value clause. The court held royalties on these leases were to be calculated on the basis of the proceeds since that gas was being sold at the well. *See id.* at 416.

29. *See id.* at 417. Volume weighted average is computed by totalling all of the prices in the field or in the area. This figure is then divided by the total volume of gas delivered in the area or field, which results in an average price based on volume of gas. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 362-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

30. 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

31. *See id.* at 359. Market value is determined at the time of delivery, not when the gas sale contract was executed. *Id.* at 357.

32. *See id.* at 362. Exxon's field price was a weighted average of prices in the area and was used by Exxon as its field prices for market value determination. *See id.* at 362-63.

33. *See id.* at 362-63 (interstate gas sales not comparable for market value determination

Finally, the court elaborated upon *Vela's* comparable sales test and established a more specific framework for market value determination.[34]

An opposite result was reached in *Exxon Corp. v. Jefferson Land Co.*[35] wherein the Beaumont Court of Civil Appeals approved of Exxon's field price.[36] The court, however, limited the sales applicable to the field price to those sales for contracts entered into after January 1, 1973, applying the comparable sales test in *Vela.*[37] Thus, while all three courts were construing similar market value leases[38] and the decisions purportedly followed *Vela,* three different meth-

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with intrastate gas sales).

34. *See id.* at 362. Guidelines for market value are:

> (1) the relevant marketing area is the field in which the gas was produced; (2) the market price of gas is to be determined by reference to sales of gas comparable in time, quality and availability to marketing outlets; (3) the mathematical average of all prices paid in the field is not a final answer to determining market value price at any particular time; (4) the relevant period of time to be used in determining the amount that should have been paid to the royalty owners is the specific period in question; and (5) an expert's opinion based upon a mathematical average of prices paid in the field and corroborated by comparable sales from the field during the relevant period may afford a basis for determining market price.

Id. at 362.

35. 573 S.W.2d 829 (Tex. Civ. App.—Beaumont 1978, no writ).

36. *See id.* at 831. *Contra,* Exxon Corp. v. Middleton, 571 S.W.2d 349, 362 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted); Butler v. Exxon Corp., 559 S.W.2d 410, 417 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

37. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ). The weighted average market price excludes gas sales under pre-1973 contracts. The court noted that the price of gas increased from 20 cents per Mcf in 1972 to over $2.00 per Mcf in 1975. *Id.* at 831.

38. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 830 (Tex. Civ. App.—Beaumont 1978, no writ) ("pay . . . the market value at the well of one-eighth (⅛) of the gas so sold or used . . . ."); Exxon Corp. v. Middleton, 571 S.W.2d 349, 356 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted) ("[R]oyalties [shall be] . . . the market value at the well of one-eighth of the gas so sold or used . . . ."); Butler v. Exxon Corp., 559 S.W.2d 410, 413 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). In *Butler,* two different types of leases were at issue. One type was the same as that found in *Jefferson* and *Middleton.* The first lease similar to those construed in *Jefferson* and *Middleton* provided for "royalties . . . on gas . . . sold or used off the premises . . . the market value at the well of one-eighth of the gas so sold or used." Further, the lease provided "on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale." Butler v. Exxon Corp., 559 S.W.2d 410, 412 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). The court held that even though delivery on three of the wells was made 100 yards from the lease boundary, the sale was nevertheless "at the well" and the royalty must be computed on the basis of the proceeds. *Id.* at 416. In the second lease, the royalty clause provided for royalties based on "one-sixteenth . . . of the market value at the well of all gas produced and saved from the leased premises." In construing this lease, the court applied *Vela* and held market value is determined at the time of sale. *Id.* at 416.

ods of market value determination have resulted in an unsettled conflict.[39]

Vela Test In Need of Redefinition

Because of the broad scope of *Vela's* test of sales comparable in time, quality, and availability to marketing outlets, the *Vela* decision needs to be distinguished or the test for market price redefined.[40] The courts should devise a workable and definitive rule for determining market value.[41] For the most part, a majority of leases were amended after *Vela*, and in those that have been renegotiated subsequently, the method of calculating royalties has been changed.[42] Nevertheless, the problem of determining market value exists for those gas leases that remain burdened with a market value or market price royalty clause.

Under *Vela*, a sale of gas occurs at the time of delivery, not at the time of the execution of the gas sales contract.[43] This rationale was followed in three *Exxon* cases.[44] If time of sale is at the time of delivery and all the gas is being "delivered" simultaneously, then all of the gas in the field is being sold at the same time. All of the gas is being delivered simultaneously because the gas is either pumped or is flowing constantly into the pipelines. Since sales comparable in time are evidence of market value, it would seem that every sale of gas in the field would fit under the standard. Surely this was not the court's intent; rather, sales comparable in time were meant to be sales occurring pursuant to contracts executed at approximately the same time.[45] The conclusion that the concept of comparable sales in time means all the sales in the field is a possible

39. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 832 (Tex. Civ. App.—Beaumont 1978, no writ); *cf.* Kelly, *What Price, Gas?*, 7 ST. MARY'S L.J. 333, 335-36 (1975) ("further litigation with higher stakes").

40. *See* Kelly, *What Price, Gas?*, 7 ST. MARY'S L.J. 333, 335 (1975).

41. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 832 (Tex. Civ. App.—Beaumont 1978, no writ).

42. *See* Hooper & Schleier, *Current Use and Effect of Division and Transfer Orders*, 18 S. TEX. L.J. 531, 539 (1977).

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

44. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ); Exxon Corp. v. Middleton, 571 S.W.2d 349, 357 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted); Butler v. Exxon Corp., 559 S.W.2d 410, 416 (Tex. Civ. App.—El Paso 1978, writ ref'd n.r.e.).

45. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ) (contracts executed prior to January 1, 1973 excluded).

one, and therefore the comparable "in time" portion of the test requires clarification.

Comparable sales, according to *Vela*, must also be comparable in quality.[46] It would seem the court in *Vela* regarded quality as referring to the physical properties of gas.[47] Quality, however, could also refer to the characteristic of being regulated gas or unregulated gas. Accordingly, certain sales of interstate gas could be excluded from market value determination because of their regulated characteristic or quality.[48]

Another element of the *Vela* test, sales comparable in availability to marketing outlets, seems archaic considering that today's intrastate gas has little difficulty in reaching an available marketing outlet.[49] This standard could be applied, however, to differentiate between sales of gas produced from greater depths than other sales. Sales of gas produced from deeper formations require higher exploration and production costs to deliver the gas to the marketplace. This deeper gas is of a later vintage[50] and commands a higher price than gas discovered at earlier periods.[51] Other than difficulty in exploration and production, the availability to marketing outlets has no real meaning in today's gas industry.[52]

46. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872 (Tex. 1968).

47. *See id.* at 872.

48. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 362-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted); *cf.* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978) (intrastate sales excluded from market value determination of interstate gas), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

49. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 352-54 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

50. Vintage means gas of a different age. As applied in the interstate market, gas is vintaged by the date of commencement of the well. *See* Tenneco Oil Co. v. FERC, 571 F.2d 834, 837-38 (5th Cir. 1978). Vintaging gives newer gas a higher price and older gas a lower price to lessen the higher price's effect on the consumer. *See id.* at 840. This method was approved in *Permian Basin Area Rate Cases,* 390 U.S. 747, 756 (1968). Gas is vintaged as pre-January 1973, post January 1973, and post January 1975. Tenneco Oil Co. v. FERC, 571 F.2d 834, 837 (5th Cir. 1978).

51. *See id.* at 847.

52. *Vela's* comparability of sales test was derived almost verbatim from Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 199 (5th Cir.), *cert. denied,* 329 U.S. 714 (1946). *See* Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 74 (Tex. Civ. App.—San Antonio 1966), *aff'd,* 429 S.W.2d 866 (Tex. 1968). In *Bynum,* there was major concern that a market price would be difficult to establish because in 1946, only a local market existed which used the natural gas in the manufacture of gasoline and carbon black. Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198 (5th Cir.), *cert. denied,* 329 U.S. 714 (1946). The gas did not have the accessibility to market that gas has today and availability to market was an important factor in determining market price, because without a market there would be no market price. *Id.* at 198; *see*

The Typical Gas Royalty Clause

The supreme court in *Vela* and the courts of civil appeals in the *Exxon* cases have failed to recognize that the lease relied on in *Vela* provided for royalties on the basis of continuing sales.[53] In *Foster v. Atlantic Refining Co.,*[54] followed closely by the court in *Vela,* the lease and the royalty clause are atypical of leases used in the gas industry.[55] It is clear in the *Exxon* trilogy the leases construed were of the more common variety and did not imply a continuing sale of gas. The conclusion in *Vela* that time of sale equals time of delivery seems incorrect if applied to the ordinary lease, because a continuing sale cannot be implied. Rather, the sale was intended to be at the execution of the gas sales contract.[56] Obviously, the parties could not have intended for the sale of gas to mean a daily occurrence because that inference is totally inconsistent with the sale of natural gas.[57] *Vela,* therefore, should not be blindly applied in all market value determination cases, but should be restricted to those cases in which the lease contains a continuing sales clause.[58] In the typical

Railroad Comm'n v. City of Austin, 524 S.W.2d 262, 274 (Tex. 1975) (no market for Panhandle field gas).

53. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 880 (Tex. 1968) (Hamilton, J., dissenting); Butler v. Exxon Corp., 559 S.W.2d 410, 419 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (Preslar, C.J., dissenting); Ashabranner, *The Oil & Gas Lease Royalty Clause—One-Eighth of What?,* 20 Rocky Mtn. Min. L. Inst. 163, 178 (1975) *(Foster* turned squarely on the language of the lease). *But see* Kingery v. Continental Oil Co., 434 F. Supp. 349, 353-54 (W.D. Tex. 1977) *(Vela* and *Foster* not decided on particular language in the lease), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978). A continuing sale may be implied from the lease in *Foster* by the use of the words "when run" indicating that market price is to be determined at the time the gas was "run" or delivered to the pipeline. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 489 (5th Cir. 1964); Kelly, *What Price, Gas?,* 7 St. Mary's L.J. 333, 334 n.6 (1975). In *Vela,* the lease provided for market price "while" the same is being sold—and because of the use of the present tense of "while," the lease implies a sale on a continuing basis. *See* Butler v. Exxon Corp., 559 S.W.2d 410, 420 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (Preslar, C.J., dissenting).

54. 329 F.2d 485, 488 (5th Cir. 1964).

55. *See* Butler v. Exxon Corp., 559 S.W.2d 410, 418-20 (Tex. Civ. App.—El Paso, 1977, writ ref'd n.r.e.) (Preslar, C.J., dissenting); Kelly, *What Price, Gas?,* 7 St. Mary's L.J. 333, 334, 344 (1975); Morris, *The Gas Royalty Clause—What Is Market Value?,* Sw. Legal Foundation 25th Inst. on Oil & Gas Law & Tax. 63, 63 (1974).

56. *See* Kelly, *What Price, Gas?,* 7 St. Mary's L.J. 333, 338 (1975).

57. *See* Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198 (5th Cir.), *cert. denied,* 329 U.S. 714 (1946). When seeking market value the court cannot apply rules of daily sales and daily quotations. The nature of the commodity renders it impossible to transact business "on the basis of daily market fluctuations." *Id.* at 198; *see* Kelly, *What Price, Gas?,* 7 St. Mary's L.J. 333, 337-38 (1975).

58. Morris, *The Gas Royalty Clause—What Is Market Value?,* Sw. Legal Foundation 25th Inst. on Oil & Gas Law & Tax. 63, 75 (1974). *See* Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?,* 20 Rocky Mtn. Min. L. Inst. 163, 178 (1975).

lease, *Vela's* doctrine of time of sale equals time of delivery seems inapplicable, and market value should be determined at the time of the execution of the gas sales contract.

Resolving the Conflict

With the natural gas industry being called upon to provide a greater share of the nation's energy resources and with intensive regulation of the industry, a solution is warranted to solve the question of market value determination. Presently, with a market value royalty provision, neither the royalty owner nor the producer is certain that the royalties being paid are correct without a judicial determination.[59] The Texas courts therefore should either distinguish or update *Vela* and accord the industry a market value formula that may be used without continuous resort to litigation.[60]

In fashioning a definitive market value formula, the courts should bear in mind the complexities of the industry as well as the very nature of the sale of gas.[61] Additionally, the courts must consider the various covenants implied between royalty owners and producer.[62] Considering the fact that *Vela* was rendered upon an extraordinary gas royalty clause, and that the parties probably did not intend for the sale of gas to be a daily occurrence, perhaps with the typical lease the best measure for market value is the gas sales contract between the producer and gas purchaser.[63] If the contract was the result of an arm's length transaction, then that price, along with corroboration by other gas prices in the field, should be used to

59. *See* Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, 20 ROCKY MTN. MIN. L. INST. 163, 174 (1975). Unless, of course, the parties have not otherwise agreed to a certain royalty payment.

60. *See id.* at 184; Kelly, *What Price, Gas?*, 7 ST. MARY'S L.J. 333, 335 (1975); Morris, *The Gas Royalty Clause—What Is Market Value?*, SW. LEGAL FOUNDATION 25TH INST. ON OIL & GAS LAW & TAX. 63, 75 (1974) (*Vela* should not be followed).

61. *See* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966) (new willing buyer test in light of interstate gas regulation); *cf.* Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198-99 (5th Cir.), *cert. denied*, 329 U.S. 714 (1946) (nature of the commodity considered).

62. *See* Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, 20 ROCKY MTN. MIN. L. INST. 163, 165, 167 (1975); Kelly, *What Price, Gas?*, 7 ST. MARY'S L.J. 333, 336 (1975).

63. *See* Kelly, *What Price, Gas?*, 7 ST. MARY'S L.J. 333, 335 (1975); Morris, *The Gas Royalty Clause--What Is Market Value?*, SW. LEGAL FOUNDATION 25TH INST. ON OIL & GAS LAW & TAX. 63, 75 (1974); *cf.* Ashabranner, *Oil & Gas Royalty Clause—One-Eighth of What?*, 20 ROCKY MTN. MIN. L. INST. 163, 178 (1975) (*Foster*, followed by *Vela*, turned on the language in the lease). *But see* Kingery v. Continental Oil Co., 434 F. Supp. 349, 353-54 (W.D. Tex. 1977), *appeal docketed*, No. 78-1015 (5th Cir. Jan. 4, 1978).

determine market value.[64] Alternatively, *Vela's* applicability could be limited to cases in which the royalty provision implied a continuing sale as in *Foster* and *Vela.*[65] Whatever the final result, it is clear that Texas courts must resolve the question of how to determine market value of intrastate gas when the royalty provision in the lease provides for royalties based on market price or market value.[66]

THE INTERSTATE MARKET

Royalty Owners Seek Market Value

For many years, the Fifth Circuit has consistently held that producers must pay royalties on the basis of current market value or market price when the lease contained a market price or market value royalty clause.[67] After the oil embargo of 1973 and the resulting energy shortage, an enormous price disparity developed between the unregulated intrastate gas market and the regulated interstate gas market.[68] Because of the vast price differential between the two types of gas, disputes have arisen over whether regulated gas prices are comparable under *Vela* to unregulated gas prices.[69] The deci-

64. *See* Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409, 411 (5th Cir.), *cert. denied,* 323 U.S. 737 (1944).

65. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 880 (Tex. 1968) (Hamilton, J., dissenting); Butler v. Exxon Corp., 559 S.W.2d 410, 419 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (Preslar, C.J., dissenting); Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?,* 20 ROCKY MTN. MIN. L. INST. 163, 178 (1975). *But see* Kingery v. Continental Oil Co., 434 F. Supp. 349, 353-54 (W.D. Tex. 1977), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978).

66. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 832 (Tex. Civ. App.—Beaumont 1978, no writ) (question not settled); Kelly, *What Price, Gas?,* 7 ST. MARY'S L.J. 333, 335-36 (1975) (*Vela* brought about further litigation; needs to be distinguished).

67. *See, e.g.,* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 89-91 (5th Cir. 1966); Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 201 (5th Cir.), *cert. denied,* 329 U.S. 714 (1946); Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409, 411-12 (5th Cir.), *cert. denied,* 323 U.S. 737 (1944).

68. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 864 (S.D. Tex. 1978); Exxon Corp. v. Middleton, 571 S.W.2d 349, 354 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted); Hemingway, *Oil & Gas, Annual Survey of Texas Law,* 32 Sw. L.J. 163, 170-71 (1978). Because of the Supreme Court's decision in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), a regulated interstate market evolved along with the unregulated intrastate market. Shortly after the *Phillips* decision, interstate rates were slightly higher, and it was not until the mid-1960's that intrastate prices surpassed interstate prices. In the early 1970's, the energy shortage exacerbated the price differential, and intrastate prices skyrocketed to over $2.00 per Mcf from approximately 20 cents per Mcf. *See* Butler v. Exxon Corp., 559 S.W.2d 410, 412 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

69. *See, e.g.,* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978); Kingery v.

sions of the Fifth Circuit recognizing royalties based upon market value were made prior to the energy shortage and did not have as a factor the tremendous price disparity that now exists.[70] Earlier, however, that court had considered the regulated characteristics of the interstate gas industry.[71]

In *Phillips Petroleum Co. v. Bynum*[72] the court established that market price is the price producers pay for gas which is "similar in quantity, quality, and availability to market."[73] The Fifth Circuit in *Weymouth v. Colorado Interstate Gas Co.*[74] modified the traditional willing buyer test of market value and adopted a test that includes a consideration of the complexity and regulation of the natural gas industry.[75] Despite the recognition given the problem of interstate regulation in market value determination, decisions providing for royalties based on market value largely ignored the two-market character of the industry and its effect on market value determination.[76] Royalty owners have recently contended that for gas being sold in the interstate market the royalty payments from those sales should be based on a market value which is computed by using the market value of intrastate gas.[77] The decision of three

Continental Oil Co., 434 F. Supp. 349, 355-56 (W.D. Tex. 1977), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978).

70. *See, e.g.,* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966); Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 199 (5th Cir.), *cert. denied,* 329 U.S. 714 (1946); Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409, 411 (5th Cir.), *cert. denied,* 323 U.S. 737 (1944).

71. *See* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966) (new willing buyer test included regulation and its complexities).

72. 155 F.2d 196 (5th Cir.), *cert. denied,* 329 U.S. 714 (1946).

73. *Id.* at 199. The Texas Supreme Court later adopted a similar test. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872 (Tex. 1968) ("sales comparable in time, quality and availability to marketing outlets").

74. 367 F.2d 84 (5th Cir. 1966).

75. *Id.* at 90. The test in *Weymouth* is:

> [W]hat would a willing seller and a willing buyer in a business which subjects them and the commodity to restriction and regulation, including a commitment for a long period of time, agree to take and pay with a reasonable expectation that the FPC would approve the price (and price changes) and other terms and then issue the necessary certificate of public convenience and necessity.

Id. at 90.

76. *See, e.g.,* J.M. Huber Corp. v. Denman, 367 F.2d 104, 109, 119-20 (5th Cir. 1966); Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 89-90 (5th Cir. 1966); Foster v. Atlantic Ref. Co., 329 F.2d 485, 490 (5th Cir. 1964).

77. *See, e.g.,* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978); Kingery v. Continental Oil Co., 434 F. Supp. 349, 351 (W.D. Tex. 1977), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978). The Federal

federal district courts in Texas are in conflict,[78] and at least one other state court has addressed the issue and reached a divided opinion.[79]

Federal Courts in Texas in Conflict: Comparable Sales

This problem is significant because traditionally market value has been determined by evidence of comparable sales, yet in a regulated environment, prices of those sales are controlled and a question remains whether market value can exist in a regulated market.[80] A Texas case which recently addressed the problem of what sales are comparable for purposes of determining market value for interstate gas was *Kingery v. Continental Oil Co.*[81]

In *Kingery,* the court concluded market value is established by evidence of specific intrastate gas sales.[82] Conversely, two subsequent district court decisions held intrastate sales were not to be considered as evidence of interstate gas market value.[83] Both decisions distinguished *Kingery* and followed the rationale of the Supreme Court's decision in *California v. Southland Royalty Co.,*[84] in which it was held that a royalty owner's gas may be forever commit-

Energy Regulatory Commission (FERC) has the authority to grant rate increases to individual producers burdened with an increased royalty payment of interstate gas, and those producers may pass on this additional cost due to the increased royalty payments. *See* Federal Energy Regulatory Comm'n v. Pennzoil Producing Co., ___ U.S. ___, ___, 99 S. Ct. 765, 770, 58 L. Ed. 2d 773, 780 (1979). The FERC, however, is not required to relieve producers from increased royalty costs which may result from state court litigation by the royalty owner. *See id.* at ___, 99 S. Ct. at 772, 58 L. Ed. 2d at 782 (1979).

78. *Compare* Kingery v. Continental Oil Co., 434 F. Supp. 349, 351 (W.D. Tex. 1977) (intrastate sales comparable for interstate market value determination), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978) *with* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978) (intrastate sales are not comparable for interstate market value determination), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978) *and* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978) (intrastate sales are not comparable in interstate market value determination).

79. Lightcap v. Mobil Oil Corp., 562 P.2d 1, 17, 27, 32 (Kan.) (six justices concurred and dissented), *cert. denied,* 434 U.S. 876 (1977).

80. Exxon Corp. v. Middleton, 571 S.W.2d 349, 362 n.3 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

81. 434 F. Supp. 349, 351 (W.D. Tex. 1977), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978).

82. *Id.* at 351. The court also included contract negotiations for intrastate gas sales as evidence of market value. *Id.* at 351.

83. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978).

84. ___ U.S. ___, 98 S. Ct. 1955, 56 L. Ed. 2d 505 (1978).

ted to the interstate market.[85] Thus, while applying Texas law, the federal district courts in Texas have reached different conclusions on the same issue.

Only Interstate Sales Should be Considered as Comparable

Recent federal cases have illuminated the rationale for not comparing intrastate gas sales with interstate sales for the purpose of determining market value.[86] Under the *Erie* doctrine, the federal courts are bound to follow substantive state law in diversity actions.[87] The royalty owners' suits, based on the lease agreements, are actions *ex contractu,* and therefore are governed by state law.[88] Additionally, a federal court has held royalty questions do not come within the jurisdiction of the Federal Power Commission (FPC).[89] Thus, in market value determination questions, the federal courts in Texas are bound to follow *Vela,* the leading decision.[90] *Vela* provided a test of comparable sales to determine market value.[91] The court in *Vela* failed, however, to provide a method by which market value should be computed in the event of an enormous disparity between intrastate and interstate prices.[92] Nevertheless, *Vela's* comparability standard may be used to exclude and include certain

85. *Id.* at ___, 98 S.Ct. at 1960, 56 L. Ed. 2d at 513; *see* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978).

86. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 865 (S.D. Tex. 1978). *But see* Kingery v. Continental Oil Co., 434 F. Supp. 349, 351 (W.D. Tex. 1977), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978).

87. *See* Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938); Butler v. Exxon Corp., 559 S.W.2d 410, 419 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (Preslar, C.J., dissenting).

88. *See* Mobil Oil Corp. v. FPC, 463 F.2d 256, 265 (D.C. Cir.), *cert. denied,* 406 U.S. 976 (1972); Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 199 (5th Cir.), *cert. denied,* 329 U.S. 714 (1944); Lightcap v. Mobil Oil Corp., 562 P.2d 1, 8 (Kan.), *cert. denied,* 434 U.S. 876 (1977).

89. *See* Mobil Oil Corp. v. FPC, 463 F.2d 256, 258-59 (D.C. Cir.), *cert. denied,* 406 U.S. 976 (1972); *cf.* Federal Energy Regulatory Comm'n v. Pennzoil Producing Co., ___ U.S. ___, ___, 99 S. Ct. 765, 769, 58 L. Ed. 2d 779, 783 (1979) (dicta) (FERC admitted no jurisdiction over royalty rate).

90. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 159 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Kingery v. Continental Oil Co., 434 F. Supp. 349, 353-54 (W.D. Tex. 1977), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978). *But see* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862-63, 864 (S.D. Tex. 1978) (*Vela* distinguished).

91. *See id.* at 862-63, 864; Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872 (Tex. 1968).

92. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978).

sales of gas in market value determination.

Intrastate sales can be excluded on two grounds under *Vela.* First, intrastate and interstate gas prices are not comparable in quality.[93] The two commodities are conceptually and legally different.[94] Second, the two types of gas are sold in entirely different markets. Interstate sales are subject to considerable government regulation and price control. Intrastate gas, however, is controlled only by state regulatory agencies, and the price producers may charge for the gas is not subject to control.[95] Once gas is committed to the interstate market, it may not abandon the interstate market without prior FPC approval.[96] Intrastate gas, however, is in a totally free market and is committed only with respect to contractual obligations. Clearly, interstate gas is available only to the interstate market and is not available to the intrastate market.[97] Under the test of availability to marketing outlets, therefore, interstate gas is not comparable with intrastate gas because it is not available to the same markets.[98]

The federal district courts also applied *Weymouth's* revised willing buyer test.[99] Although the procedure for setting interstate gas

93. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 159-60 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862-63 (S.D. Tex. 1978) (the court in *Vela* did not address what sales are really comparable).

94. Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978). Admittedly, the court in *Vela* presumedly intended "quality" to mean the physical qualities of natural gas. Absent further definition, however, nonregulation as opposed to regulation can be considered a trait or characteristic and therefore a quality. Once natural gas enters the "jurisdictional valve" it becomes entirely different from unregulated gas in every sense but the physical sense. *See* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 89-90 (5th Cir. 1966).

95. *See* Humble Oil & Ref. Co. v. Railroad Comm'n, 133 Tex. 330, 341, 128 S.W.2d 9, 15 (1939). The Texas Railroad Commission's jurisdiction extends to pipelines, oil & gas wells, and owners and operators of pipelines and oil and gas wells. TEX. NAT. RES. CODE ANN. § 81.051 (Vernon 1978). Thus, the Railroad Commission has the power to determine where, when, and whether wells may be drilled and how much oil and gas may be produced, and can regulate the price charged by transmission companies, but not by the producer. Railroad Comm'n v. City of Austin, 524 S.W.2d 262, 268 (Tex. 1975).

96. California v. Southland Royalty Co., ___ U.S. ___, ___, 98 S. Ct. 1955, 1960, 56 L. Ed. 2d 505, 513 (1978).

97. *See id.* at ___, 98 S. Ct. at 1960, 56 L. Ed. 2d at 513 (interstate gas dedicated to FPC jurisdiction).

98. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978); *cf.* Exxon Corp. v. Middleton, 571 S.W.2d 349, 362-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted) (interstate sales not comparable in intrastate market value determination).

99. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 159 (N.D. Tex.

rates has been amended since the *Weymouth* test was adopted,[100] the underlying proposition—consideration of interstate regulation—remains valid.[101] The *Weymouth* test to determine the market value of interstate gas entails a consideration of gas that is subject to restriction and regulation.[102] Thus, the test would seem to exclude any consideration of gas not subject to similar constraints.[103] Using the *Weymouth* test, therefore, intrastate sales are not comparable to interstate sales for market value determination because intrastate sales exist in a free market and the *Weymouth* test is based upon buying and selling in a totally regulated market.[104]

1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978). *See generally* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966) (willing buyer test).

100. At the time *Weymouth* was decided, the FPC set gas rates on an individual producer basis, and each producer had to seek prior FPC approval for the price to be charged for interstate gas. *See* Permian Basin Area Rate Cases, 390 U.S. 747, 754-55 (1968). In *Permian,* the Supreme Court upheld the FPC's scheme of setting interstate gas rates according to the area in which the gas was being produced. *See id.* at 754-55. The FPC delineated seven geographical areas with ceiling prices for interstate gas. Shell Oil Co. v. FPC, 520 F.2d 1061, 1066 n.4 (5th Cir. 1975), *cert. denied,* 426 U.S. 941 (1976). The seven geographical areas were: The Permian Basin, Southern Louisiana, Texas Gulf Coast, Hugoton-Anadarko, Other Southwest, Appalachian and Illinois Basin, and Rocky Mountain. *Id.* at 1066 n.4. To arrive at the area rate, the FPC used a "cost" basis for the producer and obtained the cost for the well from various production expenses. *Id.* at 1068. Later, the FPC adopted a national rate, and this change from area rates was upheld in Shell Oil Co. v. FPC, 520 F.2d 1061, 1073 (5th Cir. 1975), *cert. denied,* 426 U.S. 941 (1976). The FPC (now Federal Energy Regulatory Commission, FERC) set a second national rate for "flowing" gas from wells commenced prior to January 1, 1973, approximately ninety percent of all interstate gas. *See* Tenneco Oil Co. v. FERC, 571 F.2d 834, 837 (5th Cir. 1978).

101. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F.Supp. 861, 862 (S.D. Tex. 1978).

102. *See* Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966) (buyer, seller, and sale are not "free"); Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978) (regulated market and commodity), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?,* 20 ROCKY MTN. MIN. L. INST. 163, 190 (1975) (no free market to base market value); *cf.* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978) (*Weymouth* controlling in interstate market value determination).

103. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978).

104. *See* Brent v. Natural Gas Pipeline Co. of America; 457 F. Supp. 155, 160-61 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862-63 (S.D. Tex. 1978).

Royalty Owner's Knowledge of Eventual Regulation

In *Kingery*, intrastate sales were held to be relevant for purposes of determining market value for interstate gas. The court reasoned that because the royalty owner's lease was executed prior to the *Phillips* decision,[105] the royalty owners could not be held to have contemplated regulation of the gas that affected their royalties.[106] This argument is specious, however, because with any lease executed after the passage of the 1938 Gas Act,[107] the royalty owners could not have expected sales of interstate gas to be free from federal rules and restrictions.[108] Accordingly, the Supreme Court recently held royalty owners are bound to have contemplated that all or a portion of the gas produced would be dedicated to interstate commerce and would be subject to federal regulation.[109] Furthermore,

105. The Court in *Phillips* extended FPC regulation of interstate gas prices to the wellhead under the authority of the Natural Gas Act of 1938. *See* Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, 677 (1954).

106. *See* Kingery v. Continental Oil Co., 434 F. Supp. 349, 354-55 (W.D. Tex. 1977), *appeal docketed*, No. 78-1015 (5th Cir. Jan. 4, 1978). Prior to *Phillips*, no court had held the FPC had jurisdiction over contractual rates charged by producers to transmission companies. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978), *appeal docketed*, No. 78-3245 (5th Cir. Oct. 16, 1978).

107. Natural Gas Act, 15 U.S.C. § 717-717w (1938). The Gas Act granted the FPC authority to regulate natural gas transported in interstate commerce, especially the rates charged by transmission companies to communities. *See id.* § 717b.

108. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 162 (N.D. Tex. 1978), *appeal docketed*, No. 78-3245 (5th Cir. Oct. 16, 1978); *see* California v. Southland Royalty Co., ___ U.S. ___, ___, 98 S. Ct. 1955, 1960-61, 56 L. Ed. 2d 505, 513 (1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 864 (S.D. Tex. 1978).

109. California v. Southland Royalty Co., ___ U.S. ___, ___, 98 S. Ct. 1955, 1960, 56 L. Ed. 2d 505, 513 (1978). Additionally, royalty owners did not object when the producers sold the gas in the interstate market and having authorized that sale, could not expect the sale in the interstate market to be free from federal regulation forever. California v. Southland Royalty Co., ___ U.S. ___, ___, 98 S. Ct. 1955, 1960, 56 L. Ed. 2d 505, 513 (1978); *see* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 162 (N.D. Tex. 1978), *appeal docketed*, No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 864 (S.D. Tex. 1978). The lease in *Hemus* was executed in 1961; thus, the royalty owners were held to have contemplated federal regulation because the lease execution was subsequent to *Phillips* and the Natural Gas Act of 1938. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 864-65 (S.D. Tex. 1978) (following *Southland Royalty)*. In *Hemus*, moreover, the gas well was completed in 1974, and therefore, interstate sales from the well were subject to FPC jurisdiction and regulation at the wellhead. *See id.* at 862, 865. The leases were executed in 1926 but were amended in 1934 and 1940. The crucial fact, however, is that drilling commenced and the gas was sold in interstate commerce after the passage of the Natural Gas Act of 1938. It was at that time the royalty owners failed to object to the sale of the gas in the interstate market. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 158 (N.D. Tex. 1978), *appeal docketed*, No. 78-3245 (5th Cir. Oct. 16, 1978). It would appear, therefore, that the critical date for determining whether the royalty owners are bound by their interstate

the royalty owners cannot reasonably expect their royalties to be calculated on the intrastate market value if they have approved the gas sale at interstate prices.[110] Having agreed, therefore, to place the gas in an entirely different market, the royalty owners cannot complain that the intrastate sales are not comparable for market value determination.[111]

Analogous Regulation and Market Value

Eminent Domain. In eminent domain proceedings, the key factor in determining market value is comparable sales.[112] When the land in question is under zoning restrictions, evidence of value of the land as if it were unrestricted is to be excluded.[113] If no reasonable probability exists that the restrictions will be lifted, evidence of value based on a use for any other purpose than that to which the land is restricted is irrelevant to prove market value.[114] Thus, in eminent domain proceedings, sales of unrestricted property in the area are not comparable as a factor in calculating market value for land burdened with restrictions.[115] When determining market value

commitment is the date when the gas was sold in interstate commerce, not when the lease was executed. If the gas was sold in the interstate market after 1938, then the royalty owners are held to have contemplated federal regulation. On the other hand, if the gas was sold in interstate commerce prior to the passage of the Natural Gas Act, then it is possible that the royalty owners could expect royalty payments based on intrastate sales. *See* Brent v. Natural Gas Co. of America, 457 F. Supp. 155, 161-62 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978). The court's conclusion in *Kingery* that royalty owners could not have contemplated federal regulation if the sale was made prior to *Phillips* was invalidated in *Southland. See id.* at 161-62.

110. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161-62 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 865-66 (S.D. Tex. 1978).

111. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161-62 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 865-66 (S.D. Tex. 1978). In addition, federal regulation of gas rates is not invalid simply because the value of the royalty is reduced. *Cf.* FPC v. Hope Natural Gas Co., 320 U.S. 591, 601 (1944) (fixing of prices is application of police power). FPC jurisdiction over interstate gas may "alter the private rights of parties" and limit the "scope of sales" comparable for market value. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 162 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

112. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 864 (S.D. Tex. 1978); City of Austin v. Cannizzo, 153 Tex. 324, 327, 267 S.W.2d 808, 810-12 (1954); Siefkin, *Rights of Lessor and Lessee with Respect to Sale of Gas and as to Gas Royalty Provisions,* SW. LEGAL FOUNDATION 4TH INST. ON OIL & GAS LAW & TAX. 181, 212 (1953) (market value is price for which product is selling).

113. *See* City of Austin v. Cannizzo, 153 Tex. 324, 330, 267 S.W.2d 808, 815 (1954).

114. *Id.* at 330, 267 S.W.2d at 815.

115. *See id.* at 330, 267 S.W.2d at 815.

of interstate gas, therefore, any evidence of the value of intrastate gas is irrelevant since the interstate gas is likewise restricted.[116]

Wartime Price Regulation. Another era in price regulation, other than interstate natural gas regulation, was the period during and immediately following World War II. Under the Emergency Price Control Act, certain prices were fixed requiring sales to be made at or below established ceiling prices.[117] In a decision concerning just compensation for sale of a product at a loss under the pricing act, the Supreme Court held the ceiling price, as established by the government, was the market value.[118] Furthermore, the Court concluded that the ceiling price applicable during the period in question was the only value that could be realized, and prices prior to the period of regulation were not relevant to the determination.[119] In a totally regulated environment, therefore, the measure of market value is the maximum price allowed under the regulations.[120] Accordingly, sales of commodities not subject to regulation are not evidence of market value of commodities subject to regulation.[121]

Brent and Hemus Are Correctly Decided

The courts in *Brent* and *Hemus* have reached correct conclusions in excluding intrastate sales as not being comparable to interstate sales.[122] The court in *Brent* further held the applicable FPC area

116. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978) (two markets for gas, one for interstate), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 865 (S.D. Tex. 1978) (only evidence of "highest and best use" allowed in condemnation). *Contra,* Lightcap v. Mobil Oil Corp., 562 P.2d 1, 8 (Kan.), *cert. denied,* 434 U.S. 876 (1977).

117. *See* United States v. Commodities Trading Corp., 339 U.S. 121, 123-24 (1950) (price of blackpepper). Similarly, in the interstate gas market, all sales must be made at or below FPC estalished ceiling prices. Tenneco Oil Co., v. FERC, 571 F. 2d 834, 837 (5th Cir. 1978).

118. United States v. Commodities Trading Corp., 339 U.S. 121, 124 (1950).

119. *See id.* at 124.

120. *Id.* at 124; *accord,* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

121. *See* United States v. Commodities Trading Corp., 339 U.S. 121, 124, 129 (1950). Commodities Trading was not allowed to introduce evidence of sales prior to the imposition of price controls. *Id.* at 128-29; Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 864 (S.D. Tex. 1978).

122. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 362-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted). Gas sold in the interstate market was not comparable with intrastate gas for purposes of market value determination because the interstate gas had a lower price and a comparison would result in an inaccurate reflection of market value. *Id.* at 362-63.

rates were evidence of market value.[123] The holding is in accord with a previous Supreme Court decision which held the maximum ceiling price in a regulated market was market value.[124]

Using the FPC area rates to determine market value is the most logical approach. The FPC area rates appear to be the only rates that fit within the comparability test of *Vela*.[125] The applicable area rates are tied to sales that are comparable in time in that the area rates apply to certain vintages of gas.[126] Area rates are also comparable in availability to marketing outlets since the rates can be distinguished on the basis of specific geographical areas.[127] In addition, the availability to marketing outlets standard is satisfied since only gas from the interstate market is used for comparison, the two types of gas being in distinct markets.[128] Thus, in using the *Vela* test, the FPC area rate is a valid price under comparability of sales.[129]

Using the *Weymouth* test of market value, applicable only to a regulated market, the fettered willing seller and willing buyer in seeking a price for the interstate gas would have to accept the FPC rate.[130] In *Weymouth,* the test is "what would a willing seller and a

123. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978). Under the facts in *Brent,* the court held the FPC area rate *was* market value. *Id.* at 161.

124. *Compare* United States v. Commodities Trading Corp., 339 U.S. 121, 124, 129 (1950) *with* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

125. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 159 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978). *But see* Exxon Corp. v. Middleton, 571 S.W.2d 349, 362-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted). Texas courts will not apply *Vela* to regulated interstate gas because there can be no market value in a requlated market. *Id.* at 362 n.3.

126. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161-62 (N.D. Tex. 1978) (distinguished gas on basis of vintage), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

127. Area rates are those established by the FPC (now FERC) for the seven geographical areas. Now, however, the FERC sets prices on the basis of a national rate. Approximately ninety percent of the gas sold interstate is subject to the national rate. *See* Tenneco Oil Co. v. FERC, 571 F.2d 834, 837 (5th Cir. 1978). Thus, approximately ten percent of interstate gas still remains subject to area rates or the older individual producer rates because of several factors, ranging from the time of discovery to the type of gas. While it seems logical to apply the national rate to determine market value in most cases, some wells are still subject to individual rates or area rates. *See id.* at 837.

128. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978) (*Vela* standard satisfied because of "like market"), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

129. *See id.* at 161.

130. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Ashabranner, *The Oil and Gas*

willing buyer . . . agree to take and pay. . ."[131] and in the interstate market that figure would be the FPC rate.[132] Thus, the FPC area rate is the only price the willing buyer and seller could accept for the sale of interstate gas. Market value for interstate gas under *Weymouth,* therefore, is the FPC area rate.[133]

Now that interstate gas is priced upon a national rate basis, the same argument used to justify calculation on the basis of area rates is equally as strong. The national Federal Energy Regulatory Commission (FERC) rate for interstate gas can be limited in scope to fit the test of comparable sales in *Vela.* First, the prices under the new rate can be differentiated on the basis of time, which would be when the drilling commenced or when the gas purchase contract was executed. Gas of a different vintage can be distinguished and therefore come within the *Vela* test.[134] Second, while using the national rate, the old area rate boundaries could separate gas prices on the basis of *Vela's* criterion for availability to marketing outlets.[135] If national rates were taken solely from the area in question, then rates from other areas would not be allowed as evidence of market value.[136]

In calculating national rates, the FERC[137] arrived at the average cost of a gas well and determined the royalty expense on the basis of a percentage of the gross receipts from the gas sale.[138] Since the FERC has already calculated the royalty cost as a percentage of the proceeds, then it seems logical that the royalties should be based on the national rate prescribed by the FERC. Using a national rate to determine market value does not necessarily mean these royalties would be calculated on a "proceeds" basis; rather, such payments

Lease Royalty Clause—One-Eighth of What?, 20 ROCKY MTN. MIN. L. INST. 163, 190 (1975) ("neither the buyer nor the seller . . . free to negotiate").

131. Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966).

132. *See* Brent v. Natural Gas Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

133. *See* Brent v. Natural Gas Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

134. In *Vela,* the court established the comparability of sales proximate in time standard, yet also defined time of sale as the time of delivery of the gas. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968).

135. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161-62 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

136. *See id.* at 161-62.

137. The FPC was terminated, and all FPC functions were assumed by the Federal Energy Regulatory Commission with the creation of the Department of Energy. *See* Department of Energy Organization Act, 42 U.S.C.A. §§ 7171, 7172, 7293 (West Supp. 1978).

138. *See* Shell Oil Co. v. FPC, 520 F.2d 1061, 1068 (5th Cir. 1975), *cert. denied,* 426 U.S. 941 (1976).

would be determined by the market value of the gas as evidenced by comparable interstate sales under the FERC rate.[139]

Using the comparability of sales test in *Vela,* the revised market value test in *Weymouth,* and analogous regulated market decisions, it appears that the results in *Hemus* and *Brent* are the correct approaches to interstate gas market value determination. This conclusion is especially true in *Brent* wherein the court prescribed FPC area rates to be the proper evidence of market value,[140] and excluded intrastate prices as not comparable.

NATURAL GAS POLICY ACT OF 1978

Regulation of Intrastate Gas

The Natural Gas Policy Act of 1978 (NGPA)[141] is an attempt by Congress to encourage natural gas production without providing windfall profits to producers and gas transmission companies.[142] To effectuate this goal, Congress established different categories of gas[143] and raised the price on most gas by providing a floor price and a ceiling price. Also, for the first time, intrastate gas will be subject to federal regulation.[144] For market value purposes, therefore, the most important aspect of the NGPA is that it extinguishes the jurisdictional distinction between intrastate and interstate gas. No longer can the two be considered legally and conceptually different commodities. Under the NGPA, all sales of natural gas are controlled by the maximum and minimum rates.[145] Thus, the NGPA essentially constitutes price regulation of an entire national market.[146]

The Act establishes a complex system of pricing for all natural

139. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

140. *See id.* at 161.

141. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92 Stat. 3350.

142. *See* President's Message to Congress outlining the National Energy Plan, 13 WEEKLY COMP. OF PRES. DOC. 578 (April 20, 1977); FINAL REGULATIONS AMENDING AND CLARIFYING REGULATIONS UNDER THE NATURAL GAS POLICY ACT AND THE NATURAL GAS ACT, 44 Fed. Reg. 16,895, 16,897 (1978).

143. *See* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,452-453 (1978).

144. *See id.* at 56,451.

145. *See id.* at 56,451. Under the NGPA, however, existing contract prices which are lower than the ceiling price will not be affected by the act. Thus, all gas will not be sold at the ceiling price. *See id.* at 56,451.

146. *See id.* at 56,452.

gas. Prices for natural gas now depend on factors such as whether the gas is old or new,[147] offshore or onshore,[148] intrastate or interstate,[149] and whether the producer is a large producer or small producer.[150] Thus, as gas enters the "jurisdictional valve"[151] it will be automatically and almost permanently dedicated to a certain price category.[152] Therefore, the two-tier market no longer exists; instead one large national market exists with multiple price tiers.[153] Thus, with all the different prices and regulations, it will be difficult to apply the traditional rules of market value determination to the NGPA market. Additionally, certain categories of natural gas, predominantly former intrastate gas, will be deregulated beginning in 1985,[154] which portends a return to a more simplified two-tier market system as exists today.

Market Value Under the NGPA: Vela's Legacy

All wellhead natural gas under the NGPA, including gas sold in the intrastate market, that is sold after December 1978 will be sub-

147. *See* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, §§ 1, 103, 92 Stat. 3350.

148. *See id.* §§ 102-03.

149. *See id.* §§ 104-05.

150. *See* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,553 (1978).

151. Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 89 (5th Cir. 1966).

152. *See* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, § 2(18)(A), 92 Stat. 3350. Natural Gas may move from an intrastate category to an interstate category and vice-versa, under certain circumstances. *See* H.R. CONF. REP. No. 95-1752, 95th Cong., 2d. Sess. 1, 71-72, *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 9161, 9166. For example, gas which at one time is sold in the intrastate market may be resold in the interstate market and become dedicated. *See id.* at 9166. Also, gas currently for sale in the interstate market may be sold later in the intrastate market. *Id.* at 9166. Natural gas can lose its status as dedicated interstate if the interest owner (of the gas) in the leasehold acquires his interest pursuant to a reversion or termination of the leasehold. *Id.* at 9166. Congress intended "successor in interest" under § 2 of the NGPA to exclude one who succeeds in interest pursuant to a reversion or termination of the leasehold interest; thereby limiting the extent of the *Southland Royalty* decision. *See id.* at 9166. In addition, gas is not considered dedicated to the interstate market if it was dedicated by one who had no right to "explore for, develop, produce, or sell such natural gas" on May 31, 1978. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, § 2(18)(B)(iii)(I), 92 Stat. 3350; *see* H.R. CONF. REP. No. 95-1752, 95th Cong., 2d Sess., 1, 71-72, *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 9161, 9166 (applies to affiliates). Thus, if one is a successor in interest (except one succeeding by reversion or termination) to a leasehold interest in which the gas is dedicated to interstate commerce, and has the right to explore, develop, produce, or sell the gas, then the gas remains dedicated. *See id.* at 9166.

153. *See* H.R. Conf. Rep. No. 95-1752, 95th Cong., 2d Sess., 1, 71-72, *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 9161, 9166.

154. *See* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, § 121, 92 Stat. 3350.

ject to price ceilings.[155] Gas committed to contracts prior to December 1978 will be regulated, but will not necessarily receive the maximum price. Thus, a price differential will remain for sometime between the various categories of gas and between the various gas prices within the individual categories.[156] The enormous price disparity in *Hemus,* while perhaps mitigated in certain instances by the NGPA, will still exist.[157]

In the *Vela* decision, the court did not consider the total regulation that the NGPA mandates.[158] The principle that comparable sales are determinitive of market value is still valid, but the comparable sales test is of no value in a market with a vast price differential.[159] Thus, the question of what sales are comparable under the NGPA is uncertain. Subsequent to the *Vela* decision, and because of the price spiral of the 1970's, fewer gas sales contracts have been made for long-term commitments than in the past.[160] The majority of leases now contain clauses to mitigate the effects of rising gas prices and remedy the market value royalty problem.[161]

Total Regulation of the Marketplace

Because natural gas sold after December 1978 will be subject to price regulation and a new national multiple price market will exist, the industry and the courts must develop a method of market value determination that will reflect these transformations. This new method for market value determination should be based on principles relied on in the past. The courts should consider similar instan-

155. *See* Federal Energy Regulatory Comm'n v. Pennzoil Producing Co., ___ U.S. ___, ___ 99 S. Ct. 765, 768 n.3, 58 L. Ed. 2d 773, 778 n.3 (1979).

156. *See id.* at ___, 99 S. Ct. at 768 n.3, 58 L. Ed. 2d at 778 n.3 (1979).

157. *See id.* at ___, 99 S. Ct. at 768, 58 L. Ed. 2d at 778 (1979). *See generally* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 867 (S.D. Tex. 1978) (present enormous disparity between prices in the two markets).

158. In *Vela,* some of the gas being sold from the field in question was being sold in interstate commerce and subject to federal regulation, but the disparity in prices was approximately 15 cents per Mcf, and not a ten-fold difference as today. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 870 (Tex. 1968). Further, *Vela* was not written with the knowledge that both intrastate and interstate markets would someday be subject to federal regulation.

159. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978). *Vela* does not solve the problem of comparing intrastate with interstate sales. *Id.* at 863.

160. *See* Hooper & Schleier, *Current Use and Effect of Division and Transfer Orders,* 18 S. TEX. L.J. 531, 539 (1977). Leases have been amended since *Vela* to provide a gas royalty clause which measures value of gas on the basis of the amount received by the producer for the gas. *Id.* at 539.

161. *See id.* at 539.

ces of market regulation and market value tests devised under comparable circumstances in formulating a test for market value under the broad regulatory scope of the NGPA.

It would therefore be helpful to recall a period in which similar price controls were in effect and the federal government mandated the maximum possible price. World War II price controls provide a valid analogy to the price controls imposed by the NGPA. The Supreme Court, in attempting to determine market value for a commodity subject to regulation, looked only to the maximum ceiling price allowed by statute for the commodity.[162] In that instance, the ceiling price represented the only value that could be realized and the market value as well.[163] With respect to gas under the NGPA, the applicable ceiling price[164] is the highest value allowed by the statute.[165] Moreover, if the only value allowed for gas is the ceiling price, floor price or any other value established by the Act, then that value, the value at which all legitimate sales must occur,[166] is also the market value.[167]

While some prices of gas may not reach the ceiling price as do other prices within that category of gas,[168] the ceiling price should remain the market value.[169] Because certain types of gas are initially priced at below ceiling while others are priced at ceiling,[170] it is

162. *See* United States v. Commodities Trading Corp., 339 U.S. 121, 124 (1950).

163. *Id.* at 124.

164. Under the NGPA, the maximum ceiling price is established for each category of gas as of the date of enactment, December 1978 or April 1977, depending on the particular category. This ceiling is adjusted monthly by an inflation factor composed of a percentage of the nation's gross national product and a correction factor which is a constant number. *See* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, §§ 101-09, 92 Stat. 3350.

165. The NGPA established the various maximum "lawful" prices. Section 504 makes it unlawful to sell gas in excess of any maximum lawful price under the act. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, § 504, 92 Stat. 3350. Producers may not assume any NGPA ceiling price which is higher than their contract price, unless a specific provision so provides. *See* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,451 (1978).

166. *See id.* at 56,451.

167. *See* United States v. Commodities Trading Corp., 339 U.S. 121, 124 (1949); Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

168. *See* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,452 (1978). Because of contractual commitments, not all gas will immediately rise to the initial ceiling price. *Id.* at 56,452.

169. *See* United States v. Commodities Trading Corp., 339 U.S. 121, 124, 129 (1949); Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

170. *See* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, §§ 104-06, 92 Stat. 3350.

doubtful the various prices within a category will ever reach an equivalent level.[171] That is, not all prices will be the same within any one category because of the monthly inflation adjustment factor and the fact that they begin at different levels.[172] Compliance with *Vela* and the comparability of sales test would require locating all of the prices of that gas in the area and comparing them in order to compute market value.[173] Clearly therefore, the simplest and correct method would be to base the market value on the ceiling price as of December 1978 and adjust it monthly by the inflation factor.[174]

While not only the simplest approach, using the NGPA ceiling price as market value appears to be the correct method under *Weymouth.*[175] The basic tenet in the *Weymouth* market value test is sound: in a totally regulated market, the sale is not free, whatever price the buyer and seller can accept pursuant to regulation is market value.[176] Thus, the ceiling price would be, according to *Weymouth,* the market value because it is the maximum price and perhaps the only price the buyer and seller could "agree to take and pay" under the NGPA.[177]

For gas not being sold at the ceiling price, however, the market value price would be greater than the price of the gas being sold by the producer. Thus, royalty owners whose royalties are determined from sales of gas sold below the ceiling price would benefit by having their royalties calculated on the higher ceiling price for the particular category. Moreover, those royalty owners whose royalties are

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171. Federal Energy Regulatory Comm'n v. Pennzoil Producing Co., ___ U.S. ___, ___, 99 S. Ct. 765, 768 n.3, 58 L. Ed. 2d 773, 778 n.3 (1979).

172. *See* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, §§ 104-06, 92 Stat. 3350; FINAL REGULATIONS AMENDING AND CLARIFYING REGULATIONS UNDER THE NATURAL GAS POLICY ACT AND THE NATURAL GAS ACT, 44 Fed. Reg., 16,895, 16,896 (1979).

173. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ); Exxon Corp. v. Middleton, 571 S.W.2d 349, 362 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

174. For example, the maximum lawful price (ceiling) for new onshore production wells in December 1978 was $1.969 per MMBtu. For the same gas, the maximum price will be adjusted by an incremental amount to reflect inflation. *See* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,553 (1978).

175. *Cf.* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978) (FPC area rate is market value, following *Weymouth), appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

176. *See id.* at 161; *cf.* United States v. Commodities Trading Corp., 339 U.S. 121, 124 (1950) (market value is maximum price allowed by law).

177. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978). *See generally* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448 (1978).

determined from sales of gas sold at the ceiling price would suffer no loss because their royalties would be based on the highest price allowed by law which has been held to be market value.[178]

Conversely, some producers might be caught paying royalties based on a ceiling price while selling the gas at a lower price in the category. This anomaly has been upheld by the courts in *Vela* and *Foster*.[179] When the producer is paying royalties based upon the ceiling price while also receiving the ceiling price from selling the gas, the producer will not be burdened with paying more in royalties than he receives for the gas. Instead, the producer would benefit by paying the royalty owner a fractional share of the "proceeds" from the sale.[180] By using the ceiling price under the NGPA as market value, the producer would finally have a method for market value determination that could be relied upon without using weight-averages, field prices, or resorting to litigation.

Thus, to determine market value for a given period under the NGPA, the producer would first ascertain the appropriate category for his gas. Next, the producer would find the ceiling for that category as of December 1978 and would then adjust that figure using the monthly inflation factor for the applicable number of months.[181] In light of analogous postwar determinations, this process of using the maximum ceiling, as modified by adjustments for inflation, as the only evidence of market value seems equitable to both producer and royalty owner. Further, using the ceiling price as evidence of market value is consistent with the holding in *Brent* that area rates are the equivalent of market value.[182] Of foremost importance is the

178. *See* United States v. Commodities Trading Corp., 339 U.S. 121, 124 (1950); *cf.* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978) (FPC rate for gas is market price); *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

179. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 489 (5th Cir. 1964) (financial burden no defense); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968) (following *Foster).*

180. While it might seem that the producer would be paying royalties merely on the proceeds, the fact remains that royalties are to be paid on the market value of the gas and that market value is measured by the current ceiling price for the particular month, for the particular category. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

181. *Cf.* United States v. Commodities Trading Corp., 339 U.S. 121, 124 (1950) (ceiling price is market value); Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978) (maximum area rate allowed by FPC is market value), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

182. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 162-63 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

need for a comprehensible solution to market value royalty determination in light of the extreme complexities of the NGPA.

Dedication of Gas Subjects It to Regulation

Interstate gas. For all interstate gas sold under the NGPA, whether under existing interstate contracts or pursuant to contracts executed after December 1978, the royalty owners cannot complain of increased federal regulation and concomitant reduction in royalty payments if their royalties are based solely on the category ceiling price.[183] Royalty owners of interstate gas are held to contemplate that federal regulations would one day restrict the sales of interstate gas.[184] Once the gas is sold in the interstate market under the provisions of the NGPA, the gas might be forever dedicated to the interstate market.[185] The interstate royalty owner, therefore, has no voice in deciding whether the gas from his lease is sold subject to the NGPA. Whatever price the producer may receive under the NGPA will bind the royalty owner and will determine the royalties since the producer cannot choose his category.

The royalty owner, as lessor of a gas lease with the gas being sold under one category, should not be entitled to a market value based upon the ceiling price of another NGPA category.[186] Legally and conceptually, gases of separate categories are different commodities.[187] Additionally, the producer is not free to market the gas in the

183. *See* California v. Southland Royalty Co., ___ U.S. ___, ___, 98 S. Ct. 1955, 1960-61, 56 L. Ed. 2d 505, 513-14 (1978); Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161-62 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 865 (S.D. Tex. 1978).

184. *See* California v. Southland Royalty Co., ___ U.S. ___, ___, 98 S. Ct. 1955, 1960-61, 56 L. Ed. 2d 505, 513-14 (1978). The parties are not dedicated; rather, it is the gas that is dedicated to FPC jurisdiction. *Id.* at ___, 98 S. Ct. at 1960, 56 L. Ed. 2d at 513.

185. *See* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,451 (1978). If the gas comes within the exception of § 2(18)(A) of the NGPA, then it may not be dedicated to interstate commerce. *See* H.R. CONF. REP. No. 95-1752, 95th Cong., 2d Sess. 1, 71-72, *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 9161, 9166. For example, gas can become undedicated because of reversion or termination of the leasehold interest. *See id.* at 9166.

186. *Cf.* Brent v. Natural Gas Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978) (royalty owners not entitled to higher market value based on intrastate gas), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,451 (1978) (producers may not assume ceiling price higher than contract price).

187. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978).

higher price category because the gas is dedicated by the Act to the applicable category.[188] Therefore, royalty owners may not contend the gas if free to reach a theoretical market value.[189] Since the producer has no means to transfer gas into a higher priced category, the royalty owner is bound to accept the gas being relegated to one category and one price and the resulting royalty payments.[190]

Intrastate Gas. Computation of royalties from sales of gas committed to the intrastate market before the enactment of the NGPA will, for the most part, be free from the market value questions. After *Vela*, a majority of gas leases were amended to provide for royalties on a basis other than market value.[191] Thus the question of market value determination under the NGPA exists only for those leases containing market value provisions. The argument applicable to interstate sales with knowledge of eventual federal regulation cannot be made with respect to intrastate gas because the royalty owners did not contemplate that federal controls would, for the first time, extend to the intrastate market.[192] Therefore, only so far as this intrastate gas is concerned, it would seem that the royalty owners could demand a market value computed according to the *Vela* test of comparable sales. These sales would not be limited to a specific category, but would be those sales comparable in time, quality, and availability to marketing outlets. Thus, the same problems presented in *Butler, Middleton,* and *Jefferson* recur in computing market value for intrastate gas under the NGPA. Likewise, the same contention for overruling *Vela* or distinguishing it on the basis of a continuing sales provision could be made with intrastate sales under the NGPA. Until the Texas Supreme Court distinguishes or upholds *Vela*, the formula for determining market value under the

188. *See* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,451 (1978) (producers may not assume a higher ceiling price).

189. In the past, royalty owners have based their demands for market value on the argument that if the gas were free to be sold again it would have a higher value than the price received under the existing gas purchase contract and that this higher value, if the gas were theoretically free for resale, is the current market value. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 356 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

190. *See* California v. Southland Royalty Co., ___ U.S. ___, ___, 98 S. Ct. 1955, 1959, 56 L. Ed. 2d 505, 511-12 (1978); 43 Fed. Reg. 56,448, 56,451-452 (1978).

191. *See* Hooper & Schleier, *Current Use and Effect of Division and Transfer Orders,* 18 S. TEX. L.J. 531, 539 (1977).

192. *See* Federal Energy Regulatory Comm'n v. Pennzoil Producing Co., ___ U.S. ___, ___, 99 S. Ct. 765, 768, 58 L. Ed. 2d 773, 778 (1979).

NGPA is just as uncertain as market value computation in the pre-NGPA intrastate market.

Deregulation by the NGPA

Once the other categories are deregulated in 1985, regulatory jurisdiction will remain for interstate gas and certain types of gas.[193] The old system of a regulated interstate and an unregulated intrastate market with the two-tier market will then exist and the two types of gas will again become conceptually and legally distinct.[194] For this reason, intrastate gas and interstate gas must be considered incomparable for market value determination.[195] By 1986, however, the price disparity between the two markets may have lessened along with the number of market value leases.[196] Nevertheless, some leases will undoubtedly contain market value provisions and market value determination will therefore still be a problem. After 1986, royalty owners with market value clauses could demand market value for their royalties based on what may be a higher, unregulated intrastate rate.

For those long term leases with market price or market value clauses, the determination of market value should be made on the basis of the holding in *Brent,* updated however, to reflect the effect of the NGPA. The court in *Brent* held intrastate rates are irrelevant to interstate market value determination, and the applicable FPC area rate is the best evidence of market value.[197] Thus, to determine market value of interstate gas after NGPA deregulation in 1985, intrastate sales should be excluded as in *Hemus* and *Brent.* Furthermore, the best evidence of market value should be the maximum ceiling price as of December 1978, adjusted to the period in question

193. *See* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, § 121, 92 Stat. 3350. Interstate gas and certain Alaskan gas will remain under federal price regulation after January 1, 1985. *Id.* § 121.

194. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978).

195. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978).

196. By that time, perhaps, many of the "market price" and "market value" leases written prior to *Vela* will have been rewritten, having expired in the early 1980's. Those that have not expired by their own terms have been adjusted to cope with *Vela. See* Hooper & Schleier, *Current Use and Effect of Division and Transfer Orders,* 18 S. TEX. L.J. 531, 539 (1977).

197. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978).

for inflation, or the ceiling as later determined by the FERC.[198] Each category of gas under the NGPA would have a maximum price which would be considered market value.[199] It is that maximum price upon which the royalty payments should be based.

Thus, for all gas subject to the provision of the NGPA, market value determination should be made by calculating the maximum price for a particular category and deriving the percentage royalty from that figure. The maximum category price would be the figure derived from the NGPA's category ceiling price and adjusted monthly to reflect inflation. It would therefore be unnecessary to examine comparable sales as per *Vela,* because all of the sales in a particular category would depend on one current ceiling price for market value determination. The same would be true of the FPC (now FERC) area rates for those sales still subject to area rates: one ceiling price would be applicable for the area.

CONCLUSION

The *Vela* doctrine was established prior to the energy shortage and intrastate gas price spiral and well before federal regulation of the entire gas industry. Because of these unforeseen events,[200] *Vela* has bequeathed a legacy of conflict in judicial interpretation[201] and continued uncertainty for the future.[202]

The test of comparable sales in *Vela* was rendered at a time when very little difference existed between interstate and intrastate gas

198. *See* United States v. Commodities Trading Corp., 339 U.S. 121, 129 (1950); Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978); *cf.* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978) (intrastate sales excluded).

199. *Cf.* United States v. Commodities Trading Corp., 339 U.S. 121, 124 (1950) (ceiling price is market value).

200. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 864 (S.D. Tex. 1978) (society did not foresee enormous disparity).

201. *See, e.g.,* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ); Exxon Corp. v. Middleton, 571 S.W. 2d 349, 361-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted); Butler v. Exxon Corp., 559 S.W.2d 410, 417 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

202. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978) (*Vela* no guide when sizeable disparity in prices exists); Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 832 (Tex. Civ. App.—Beaumont 1978, no writ) (question of market value has yet to be settled by courts). *Compare* Kingery v. Continental Oil Co., 434 F. Supp. 349, 353 (W.D. Tex. 1978), *appeal docketed,* No. 78-1015 (5th Cir. Jan. 4, 1978) *with* Brent v. Natural Gas Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed,* No. 78-3245 (5th Cir. Oct. 16, 1978) *and* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863-64 (S.D. Tex. 1978).

prices.[203] Consequently, when intrastate prices exceeded interstate prices by approximately ten-fold, a proper application of the *Vela* test became uncertain.[204]

In the determination of market value for interstate gas, *Vela's* test has also been found to be inadequate.[205] Thus, *Vela* does not address the crucial issue in interstate market value determination of what sales are really comparable.[206] Furthermore, after the enactment of the NGPA, a proper solution for determining market value seems even more elusive. A test of comparable sales has little validity in a completely regulated market.[207]

If *Vela* is not overruled or distinguished on the basis of a continuing sale type provision, the comparable sales test should be more narrowly defined or a more specific guideline for market value determination should be established. Otherwise, producers will have to avoid the pitfalls of *Vela* and alter the method from paying royalties on the basis of market value to an in-kind or proceeds computation, if they have not already done so.[208] Moreover, any new test or redefinition of the current *Vela* standard must bring *Vela* in line with the economic realities of today's natural gas industry, which have arisen subsequent to the decision. First, a new test must include a consideration of the price disparity between interstate and intrastate gas before, during and perhaps after the NGPA, and the uniform pricing policy of the NGPA. Second, the very nature of the industry must be considered, especially its transformation since *Vela* and *Weymouth*. Specifically, the industry's growth, increased complexity, technical changes, and absolute regulation by the federal government must be included in any new guideline or redefinition of

203. *Vela's* comparable sales test was extracted almost verbatim from *Bynum*. *See* Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 199 (5th Cir.), *cert. denied*, 329 U.S. 714 (1946); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 868, 873 (Tex. 1968).

204. *See, e.g.*, Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, no writ); Exxon Corp. v. Middleton, 571 S.W. 2d 349, 362-63 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted); Butler v. Exxon Corp., 559 S.W.2d 410, 417 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

205. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *appeal docketed*, No. 78-3245 (5th Cir. Oct. 16, 1978); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 863 (S.D. Tex. 1978).

206. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978).

207. *See id.* at 862-63; Exxon Corp. v. Middleton, 571 S.W.2d 349, 362 n.3 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

208. Many producers have already protected themselves against *Vela*. *See* Hooper & Schleier, *Current Use and Effect of Division and Transfer Orders*, 18 S. TEX. L.J. 531, 539 (1977).

the test for market value. Additionally, the courts must fashion a solution to the market value question which will provide a market value standard that will not automatically cause a resort to litigation. When the gas market is completely regulated, however, it would appear that *Vela's* comparable sales test is of no value and while royalty owners are entitled to royalties based on current market value under *Vela* and *Foster,* the determination thereof must be based on prior decisions relating to commodities subject to complete regulation.