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Stuart C. Hollimon

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EXXON CORPORATION V. MIDDLETON: SOME ANSWERS BUT ADDITIONAL CONFUSION IN THE VOLATILE AREA OF MARKET VALUE GAS ROYALTY LITIGATION

STUART C. HOLLIMON*

* Attorney, Strasburger & Price, Dallas, Texas; B.A. St. Olaf College; J.D. Southern Methodist University; Admitted to the Bar of Texas.

I. INTRODUCTION

It has been thirteen years since the Texas Supreme Court rendered its decision in *Texas Oil & Gas Corp. v. Vela,*[1] construing the royalty obligation of a lessee under an oil, gas, and mineral lease providing for the payment of royalty on gas produced thereunder based upon a fraction of the production's market price. In *Vela,* the court held that, for gas royalty purposes, "market price" is to be determined by comparing contract prices for gas *currently* negotiated in the relevant market area, without regard to the price actually received by the lessee in sales of the subject production made pursuant to long-term gas sale agreements. The limited effect of the *Vela* decision was that the lessee was required to pay gas royalty at the currently prevailing market price for gas, as determined from time to time even though contractually bound to sell such gas at a lower price pursuant to a life-of-the-lease contract. The broader result of the decision, however, was the institution of a large volume of litigation arising under Texas law by royalty owners seeking increased gas royalty upon the theory that their respective lessees had breached a duty to pay royalty on the basis of the production's market value.[2] The initiation of such liti-

1. 429 S.W.2d 866 (Tex. 1968).

2. *See, e.g.,* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980) (consolidated appeal of *Kingery v. Continental Oil Co.,* 434 F. Supp. 349 (W.D. Tex. 1977) and *Brent v. Natural Gas Pipeline Co. of America,* 457 F. Supp. 155 (N.D. Tex. 1978)); Hemus & Co. v. Hawkins, 452 F. Supp. 861 (S.D. Tex. 1978); First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783 (Tex. Civ. App.—El Paso 1980, writ granted); Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.); Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981); Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). Similar litigation has arisen under the law of other states as well. *See, e.g.,* Domatti v. Exxon Corp., 494 F. Supp. 306 (W.D. La. 1980); Lightcap v. Mobil Oil Corp., 562 P.2d 1 (Kan. 1977); Montana Power Co. v. Kravik, 586 P.2d 298 (Mont. 1978).

gation logically coincided with the nation's energy shortage and the resultant increase in price differentials between sales of gas committed to be sold under long-term gas sale contracts made during the period when the price of gas was at relatively low levels, and sales of newly discovered reserves or sales under renegotiated gas sale contracts.

The royalty owners frequently were successful in litigation of this type, recovering market value royalties based upon the higher current gas market prices. In these cases, however, the Texas courts, and courts of jurisdictions applying Texas law, failed to provide producers and royalty owners with clear guidelines for determining the market value of the gas involved, and for determining when, if at all, to apply the market value standard. As a result, producers and royalty owners alike remained confused about how to properly determine their royalty obligations or rights.

Recently, the Texas Supreme Court attempted to clarify this area of Texas law in *Exxon Corp. v. Middleton.*[3] While *Middleton* answered some of the questions that previously plagued producers and royalty owners, the decision failed to respond decisively to all of the issues raised by *Vela*. In fact, *Middleton* has created additional problems concerning the proper determination of a producer's royalty obligation.

II. Prelude to the Explosion of Market Value Gas Royalty Litigation

The term "royalty" has come to have a well-defined meaning in the oil and gas industry and the courts as well. Royalty refers to an interest in minerals, held either by grant or reservation, which entitles the owner to a share of the product or profit obtained from the extraction of those minerals from the land as compensation for allowing another to deplete his minerals.[4] Royalty generally constitutes the prime element of consideration flowing to the lessor under an oil, gas, and mineral lease. The royalty clause in such a lease provides the standard by which the lessee's obligation to

3. 613 S.W.2d 240 (Tex. 1981).

4. *See* J. M. Huber Corp. v. Denman, 367 F.2d 104, 115 (5th Cir. 1966); Watkins v. Slaughter, 144 Tex. 179, 181, 189 S.W.2d 699, 700 (1945); Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, ROCKY MT. 20TH ANN. MINERAL LAW INST. 163, 172 (1975).

compensate its lessor, either in product or money, is established.[5] This standard, insofar as it relates to gas production, is typically based upon a fraction of either the "proceeds of the sale" of the gas, or the "market value" of the production, or the "market price" of the production, or some combination thereof.[6] The most common gas royalty provision provides that the lessee shall pay as royalty the market value at the well of a specified fraction of the gas sold or used off the lease and a fraction of the amount realized from the sale of the gas which is sold at the well.[7] The construction

5. *See generally* E. Brown, The Law of Oil and Gas Leases § 6.01 (1973 ed.); 3 E. Kunz, The Law of Oil and Gas § 40.4 (1967); W. Summers, Oil and Gas §§ 571-650 (1958); H. Williams & C. Meyers, Oil and Gas Law § 650 (1964).

6. Another type of royalty clause exists, which provides for the payment of royalty through an "in kind" transfer to the royalty owner of his share of the production by delivery thereof into the purchaser's pipeline for the benefit of the royalty owners. This clause is often employed in connection with the lessee's royalty obligation with respect to oil produced under the lease. The provision, however, is rarely found in gas royalty clauses because gas, due to its volatile nature, cannot be stored safely or efficiently and must be disposed of immediately, thus encouraging the payment of gas royalty in cash. W. Summers, Oil and Gas §§ 571-650 (1958); H. Williams & C. Meyers, Oil and Gas Law § 650 (1964). *See also* R. Sullivan, Oil and Gas § 65 (1955); Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, Rocky Mt. 20th Ann. Mineral Law Inst. 163, 195-96 (1975); Note, 46 Texas L. Rev. 291, 292 n.9 (1967).

The impact of the physical differences between oil and gas, in addition to being reflected in the terms of the respective royalty clauses, is also revealed in the marketing techniques applicable to these substances. Under the customary oil, gas, and mineral lease in Texas, full ownership of the gas in place rests with the lessee and is marketed by him without direction from the lessor. Of course, the lessee must account to the lessor for the latter's royalty share of the proceeds or value of production after it is sold. By comparison, the lessor, by the terms of the oil royalty clause in his lease, directs the lessee how to dispose of the former's share of the oil production. As indicated, the usual method provides for the lessee to deliver the lessor's oil to the pipeline to which the lessee's wells are connected. The purchaser of the lessee's oil also usually buys the royalty oil and, pursuant to division orders, agrees to pay the "posted price" (i.e., market price) in the field for the oil. The posted price applicable to such sales is that prevailing at the time the oil is "run," that is, when physical possession of the oil changes from the lessee's wells or storage tanks to the purchaser's pipeline or storage tanks. For an excellant discussion of these marketing techniques, 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).

7. The fractional amount of the royalty on oil or gas is commonly 1/8th of the production, less a proportionate share of the applicable severance tax. Of course, the amount of royalty is a matter of negotiation between the parties to the lease and will vary with the circumstances. In the past there was some distinction made between the terms "market price" and "market value" as used in gas royalty clauses. *See* Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198 (5th Cir.), *cert. denied*, 329 U.S. 714 (1946). However, in more recent times that distinction has been held to be one without a difference. *See* J. M. Huber Corp. v. Denman, 367 F.2d 104, 107 n.5 (5th Cir. 1966). For a discussion of these "standard"

of this form of gas royalty clause produced much of the recent market value gas royalty litigation.

Although the *Vela*-type market value gas royalty claim has only reached its current popularity within the past decade, the circumstances which give rise to the claim may be traced to the execution by lessees of long-term gas sale contracts coupled with the use of a market value gas royalty standard in the corresponding lease agreements.[8] These rather unfortunate circumstances were, in part, the result of the impact upon mineral lessees of their duty to market production promptly, the prevailing practicalities of marketing gas, and the inartful drafting of gas royalty clauses in oil, gas, and mineral leases. Then, as now, these leases were construed by courts to contain various implied covenants, all of which require the lessee to act in some fashion to protect the interest of its lessor.[9] One such convenant, the implied covenant to market production promptly and reasonably, obligates the lessee, once commercial production is obtained, to market the oil or gas with due diligence on the best possible terms.[10] Failure to comply with this covenant will subject the lessee to an action for damages.[11] Thus,

royalty provisions, see 1 E. BROWN, THE LAW OF OIL AND GAS LEASES §6.00 (2d ed. 1973); Comment, *The Gas Royalty Clause of an Oil and Gas Lease in Texas*, 11 SOUTH TEX. L. J. 405 (1970); Comment, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 TEXAS L. REV. 641 (1947). For cases involving the construction of these "standard" royalty provisions, see Phillips Petroleum Co. v. Bynum, 155 F.2d 196 (5th Cir.), *cert. denied*, 329 U.S. 714 (1946) ("market price"); Phillips Petroleum Co. v. Oschner, 146 F.2d 138 (5th Cir. 1944) ("market value"); Lightcap v. Mobil Oil Corp., 562 P.2d 1 (Kan. 1977) (comparable "market value" and "proceeds" clauses); Upham v. Ladd, 128 Tex. 14, 95 S.W.2d 365 (1936) ("proceeds of sale").

8. *See* Hoffman, *Oil and Gas Royalty Problems—Current Issues and Answers*, SW. LEGAL FOUNDATION 31ST INST. ON OIL & GAS LAW & TAX. 211, 211-13 (1980).

9. The implied covenants which burden the lessee's interest include, among others, the covenant to protect the lease from being drained of hydrocarbons, the covenant to reasonably develop the leased premises, the covenant to market production obtained from the leased premises with dispatch, the covenant to use reasonable care in operations conducted on the lease, and, when appropriate, the covenant to seek favorable administrative action to aid the discharge of the lessee's duties under the lease. *See generally* R. HEMINGWAY, THE LAW OF OIL AND GAS §§ 8.1-.13 (1971); 2 W. SUMMERS, OIL & GAS LAW §§ 391-400 (1959); 5 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §§ 801-85 (1964).

10. *See* Knight v. Chicago Corp., 144 Tex. 98, 105, 188 S.W.2d 564, 567 (1945); Cole Petroleum Co. v. United States Gas & Oil Co., 121 Tex. 59, 64, 41 S.W.2d 414, 416 (1931); Amoco Prod. Co. v. First Baptist Church, 579 S.W.2d 280, 285-86 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1981); Masterson v. Amarillo Oil Co., 253 S.W. 908, 914 (Tex. Civ. App.—Amarillo 1923, writ dism'd).

11. *See* Knight v. Chicago Corp., 144 Tex. 98, 105, 188 S.W.2d 564, 567 (1945); Cole

the implied covenant to market production places a great deal of pressure upon mineral lessees possessing leaseholds with potential gas production to obtain production and enter into gas sale agreements at the earliest possible date.[12]

The business realities of marketing gas, which result from the physical properties of gas itself, often preclude the prompt action required of a lessee under the implied covenant to market. Due to its volatile nature, gas cannot be produced and sold unless pipeline systems are available to transport the gas to the place it is to be consumed. Unlike liquid hydrocarbons, gas cannot be stored in surface containers, nor can it be transported by truck. Rather, gas normally is marketable only when the reserves in the field where the lease is situated justify the sizeable capital expenditure necessary to construct and lay a pipeline capable of transporting the gas to its market destination.[13] Pipeline systems, of course, are complex creatures and are quite expensive to construct. Investors traditionally have not been willing to build pipelines unless gas is available in a sufficient quantity and has been committed to the pipeline for an adequately long period, thereby providing the investors with reasonable assurance that they will make a profit on their investment. Thus, the justification for the capital expenditure necessary to construct the pipeline usually comes in the form of long-term gas sale contracts which effectively commit the volume of gas to be sold to the purchaser who will transport the gas through its pipeline to the point of consumption.[14]

Petroleum Co. v. United States Gas & Oil Co., 121 Tex. 59, 64, 41 S.W.2d 414, 416 (1931); Amoco Prod. Co. v. First Baptist Church, 579 S.W.2d 280, 285-86 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1981).

12. This is clearly shown in the area of market value gas royalty litigation. For example, the lease in *Vela* was executed in 1933 and promptly thereafter, in 1934, a gas sale contract was entered into as to this production. Other such contracts subsequently were entered into in 1935 and 1937. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 868-70 (Tex. 1968).

13. Morris, *The Gas Royalty Clause—What Is Market Value?*, SW. LEGAL FOUNDATION 25TH INST. ON OIL & GAS LAW & TAX. 63, 65 (1974).

14. *Id.* Even the courts expressly have recognized the existence of these economic "facts of life" in the gas industry. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964); Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198-99 (5th Cir.), *cert. denied*, 329 U.S. 714 (1946); Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 73 (Tex. Civ. App.—San Antonio 1966), *rev'd*, 429 S.W.2d 866 (Tex. 1968); Gex v. Texas Co., 337 S.W.2d 820, 828 (Tex. Civ. App.—Amarillo 1960, no writ). As stated by the *Foster* court:

> The practicalities of the gas industry require that gas be sold under long-term contracts because the pipelines must have a committed source of supply sufficient to

These circumstances, in conjunction with the market value gas royalty clauses contained in oil, gas, and mineral leases, began to produce inequitable results in gas royalty payment obligations during the 1960's and 1970's. During that period, the prevailing price of gas sold under relatively new gas sale agreements began to exceed the price established under older, fixed-price, long-term gas sale contracts, and the royalty payable under leases corresponding to the new contracts began to exceed that paid to royalty owners under leases corresponding to the older gas sale contracts.[15] At the same time, it became apparent that producers of gas who had executed older mineral leases, the terms of which provided for the payment of gas royalty based on the market value of gas produced thereunder, were, in fact, customarily compensating their royalty owners by payment based on the proceeds received from the sale of such gas, and not necessarily in accordance with the market value of the gas.[16] Royalty owners, believing that the gas royalty payments they had been receiving did not comport with the traditional notion of market value,[17] began to initiate actions to recover alleged underpayments of royalty, asserting that their gas royalties should have been determined by reference to the current market value of the gas, rather than the lower sales price of the gas on

justify financing, construction, and operation. The impact of this economic fact on the royalty clause of the Foster-Atlantic lease produces the problem presented here. Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964).

15. In the 1970's gas prices dramatically increased with respect to new reserves, and the differential between gas sale prices under old and new contracts became magnified. Specifically, from 1972 to the third quarter of 1975, the price of intrastate gas uncommitted to any contract rose from 20¢ per Mcf to over $2.00 per Mcf. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.); Butler v. Exxon Corp., 559 S.W.2d 410, 412 (Tex. Civ. App.—El Paso 1978, writ ref'd n.r.e.). Thus, many royalty owners became aware that while their lessee was perhaps selling (and being compelled to sell) the gas produced from their lease at 20¢ per Mcf pursuant to a 20-year contract entered into during a period of reduced demand, newly developed reserves were being sold under fresh gas sale contracts to intrastate purchasers at $2.00 per Mcf. Hoffman, *Oil and Gas Royalty Problems—Current Issues and Answers*, 31 Sw. Legal Foundation 31st Inst. on Oil & Gas Law & Tax. 211, 212-13 (1980).

16. *See* Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, Rocky Mt. Mineral Law 20th Ann. Inst. 163, 172 (1975); Kelly, *What Price, Gas?*, 7 St. Mary's L.J. 333, 338 (1975).

17. "Market value" traditionally is defined as the price property will bring when offered for sale by one who desires to sell, but is not obligated to sell, and when bought by one who desires to buy, but is under no necessity of buying. State v. Carpenter, 126 Tex. 604, 618-19 89 S.W.2d 979, 980 (1936) (on motion for rehearing); Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 830 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.).

which their royalty was actually based.[18]

Although the amount of royalty to be paid for gas pursuant to market value royalty clauses has long been the subject of litigation,[19] the specific issue involved here, the determination, for royalty purposes, of the "market value" of gas sold under a long-term contract, did not initially arise until 1964 with the Fifth Circuit's decision in *Foster v. Atlantic Refining Co.*[20] Even there, the court did not squarely face the issue in construing the terms of the royalty clause before it. In *Foster*, the mineral lease's royalty clause required the lessee to pay royalty on 1/8th of the gas produced and saved from the leased premises on the basis of the "market price . . . *prevailing* for the field where produced *when run*."[21] The lessee had entered into a twenty-year gas sale contract with respect to this production some years before and consistently had paid royalty on such gas on the basis of the proceeds received from the sale of the gas. At the time of suit, the royalty payments were based upon a contract price which was significantly below that which the royalty owners alleged was the prevailing market price for gas produced from the particular field during the time period involved.[22]

The Fifth Circuit affrmed the trial court's judgment awarding

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18. Federal courts served as the forum for the initial batch of such litigation involving the calculation of royalty with respect to gas committed to, and sold in, the interstate market. *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, 89 (5th Cir. 1966); Foster v. Atlantic Ref. Co., 329 F.2d 485, 488-89 (5th Cir. 1964). *Vela*, however, was the first *definitive* decision on the issue dealt with in this article.

19. *See, e.g.*, Phillips Petroleum Co. v. Bynum, 155 F.2d 196 (5th Cir.), *cert. denied*, 329 U.S. 714 (1946); Phillips Petroleum Co. v. Johnson, 155 F.2d 185 (5th Cir. 1946); Phillips Petroleum Co. v. Ochsner, 146 F.2d 138 (5th Cir. 1944); Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409 (5th Cir. 1944).

20. 329 F.2d 485 (5th Cir. 1964).

21. *Id.* at 490 (emphasis added). The phrase "when run," as used in connection with oil, customarily refers to the time when physical possession of the oil changes from the lessee's wells or storage tanks to the oil purchaser's pipeline or storage tanks. *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).

22. The lessee's royalty payment was based on a contract price of 10¢ per Mcf while the market price of gas in the field at the time was 13¢ per Mcf in 1957 and 14¢ per Mcf in 1958-1962. Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964). The term "Mcf" is the standard unit for measuring the volume of natural gas. It is an abbreviation or acronym for the words "thousand cubic feet." H. WILLIAMS & C. MEYERS, OIL AND GAS LAW MANUAL OF TERMS 337 (1978).

damages to the royalty owner in an amount equal to the difference between the royalty received and that which would have been received under a market value measurement. In so holding, however, the Fifth Circuit emphasized that the royalty clause *expressly* provided for the payment of royalty based upon the market price of gas prevailing in the field where the gas was produced at the time of delivery.[23] The court, therefore, was called upon to construe a royalty clause which expressly addressed the *time* when the prevailing market price was to be determined under circumstances in which the basis for determining the market value of the subject gas, and the actual market value computation as well, were not in dispute. Although the *Foster* court was not required to address the issues that frame most current market value royalty litigation, and to that extent the decision is distinguishable from the precedential decisions on the point,[24] the court did foreshadow the simplistic rationale employed by many courts addressing true market value gas royalty situations when it stated:

> Stripped of all the trimmings Atlantic's position is simply: We cannot comply. This is no answer. The lease calls for royalty based on the market price prevailing for the field where produced when run. The fact that the ascertainment of future market price may be troublesome or that the royalty provisions are improvident and result in a financial loss to Atlantic "is not a web of the Court's weaving." Atlantic cannot expect the court to rewrite the lease to Atlantic's satisfaction.[25]

Four years after the *Foster* decision the issues involved in a claim for additional royalty on gas committed for sale under a long-term contract, based upon the alleged right to have such royalty calculated by reference to the current market value of the gas, were more fully addressed when the Texas Supreme Court issued

23. The phrase "when run" was summarily construed by the court to mean the time of delivery. This was done even though that phrase is foreign to gas marketing and the gas industry generally and is indigenous only to the marketing of oil. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 489 (5th Cir. 1964). See cases and material cited note 6 *supra*.

24. Indeed, many industry representatives considered the terms of the royalty clause in *Foster* to be so unusual that they believed the "when run" language contained therein played a central role in the *Foster* court's decision and considered the *Foster* decision as being effectively limited to its facts. Consequently, the result in *Vela* surprised many persons in the industry despite the clear implication of the language in *Foster*.

25. Foster v. Atlantic Ref. Co., 329 F.2d 485, 490 (5th Cir. 1964).

its decision in *Texas Oil & Gas Corp. v. Vela.*[26] In *Vela*, the roy-

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26. 429 S.W.2d 866 (Tex. 1968). During the intervening four years, the Fifth Circuit rendered decisions in *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966) and *J. M. Huber Corp. v. Denman*, 367 F.2d 104 (5th Cir. 1966), both of which involved market value gas royalty claims. Neither decision, however, *fully* addressed the issue of the proper method for determining the market value of gas in a gas royalty claim context.

The *Weymouth* decision focused on the portion of the market value test which requires a comparison of comparable sales. The lessor asserted that the trial court erred in permitting certain expert testimony of gas sales made by other lessee-pipelines located in the vicinity of the leased premises because they were not arm's-length sales and, therefore, were not comparable market value sales. The lessor also contended that testimony of comparable sales should be limited to sales of gas from leases having market value gas royalty clauses and which were entered into at about the same time and place as the lease under examination and that resort to comparable sales should be permitted only after it is shown there is no market value for the gas in question and some reference has been made to other methods of arriving at some fair value.

The *Weymouth* court stated that, especially with regard to gas committed to the interstate market, there is never any exactly comparable sale. The court also showed that because of the complex and pervasive federal regulatory scheme applicable to interstate gas, traditional notions of market value (i.e. the price which a willing buyer would pay and a willing seller would accept, after fair negotiation, with neither party acting under compulsion) are inapplicable to such a determination to be made with regard to interstate gas. Having marshalled ample evidence to support its position that the interstate gas market is "in no sense a 'free' market," and that no interstate gas sales are truly the result of arm's-length bargaining, the *Weymouth* court concluded that all expert testimony of "fairly comparable" sales is admissible on the matter of the market value of the subject gas. Any questions of relevancy concerning such testimony were held to simply bear upon the weight of that evidence which properly would be considered by the jury in its capacity as the trier of fact.

Thus, *Weymouth* did not address the matter of how to determine market value of gas committed to be sold under a long-term gas sale agreement; rather, it addressed what evidence is admissible on the issue of comparable sales, only one small part of such a market value determination. Moreover, *Weymouth* referred the case to the Federal Power Commission (FPC), the federal agency which at that time governed the regulation of interstate gas, pursuant to the doctrine of primary jurisdiction for a determination of the agency's jurisdiction to regulate the rates to be paid as royalty on gas production. For these reasons, the *Weymouth* decision has been accorded little precedential significance in connection with market value gas royalty litigation.

The *Denman* case held that the relevant "market" to be considered in determining the market value of gas, for gas royalty claim purposes, cannot be limited to lessee-pipeline purchases. In *Denman*, the lessor asserted a claim for additional gas royalties based upon the lessee's alleged failure to pay royalty on the basis of the market value of that gas as provided in their lease. The lessee conceded that it had paid gas royalty on the basis of the proceeds from the sale of the gas, but contended that the proceeds received from the sales involved also constituted the market value of that gas. The lessee reasoned that certain actions of the lessor and lessee, taken contemporaneously with the execution of their lease, demonstrated the parties' intent to limit the market of the gas to that afforded under the gas sale contract entered into by the lessee and a third party pipeline purchaser. The actions involved consisted of the lessor having had full knowledge of the gas sale agreement and, in fact, having affirmatively participated in the commitment of the gas to the contract by realty owners squarely presented the issue of the effect, if any, of the commitment of gas under a long-term sale agreement upon a determination of the market value of the gas. The gas involved had been committed under certain life-of-the-lease sale agreements entered into shortly after the oil, gas, and mineral lease itself had been executed.[27] The lease provided for a royalty payment on gas sold or used off the premises of "one-eighth of the market price at the wells." At the time suit was filed, the price received by others under more recently executed gas sale contracts covering gas produced from the field involved far exceeded the proceeds received

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quiring the lessee to enter into the contract as a condition precedent to entering into the oil, gas, and mineral lease. Against this background, the lessee contended that because the affirmative action of the lessor, as well as the lessee, permanently channeled the subject gas into the specified gas sale contract, the lessor was bound to accept the terms of that contract as delineating the sole and exclusive market for that gas in determining its market value for royalty purposes.

The Fifth Circuit disagreed, holding that the term "market," as descriptive of the buyer in a sale, is not synonymous with the meaning of that term in fixing value; rather, in the latter context, the court held the term signifies the theoretical arm's-length transaction between the willing buyer and willing seller, neither of whom is compelled to enter into the bargain eventually made. The court was aided in its analysis by the fact that the mineral lease in question originally had contained a royalty clause which made gas royalty payments calculable upon a fraction of the net proceeds derived from the sale of gas. That clause, however, had been replaced by the market value royalty language, thus evidencing an intent by the parties to have gas royalty calculated under the lease on some basis other than actual sale proceeds.

Thus, *Denman*, as *Weymouth* did not face the matter of determining the market value of gas in the context of a gas royalty claim made with respect to gas committed for sale under a long-term contract. Indeed, the *Denman* court specifically noted that the market value question was yet to be tried and limited its attention to the issue of whether the actual purchase constituted the market. Moreover, as in *Weymouth*, the court referred the case to the FPC for a determination of the above described jurisdictional issue. For these reasons, and the added consideration that *Denman*, as *Weymouth*, simply amounted to an *Erie* "educated guess" concerning how the Texas Supreme Court would construe such a market value gas royalty clause, *Denman* has also received little precedential recognition with regard to the proper method for making market value determinations of gas involved in gas royalty claims.

27. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 868, 869-70 (Tex. 1968). The *Vela* lease was executed in 1933 and the gas sale contracts involved were signed between 1934 and 1937. When gas was first discovered on the leased premises, there was no pipeline in the field. The lessee subsequently entered into a life-of-the-lease gas sale agreement with United Gas Public Service Company in 1934 and, after acquiring various leases in the field, entered into several similar gas sale contracts with others. *Id.* at 869-70. Interestingly, the gas purchaser's rights under those contracts ultimately were assigned to a subsidiary of the defendant-lessee Texas Oil & Gas Corporation, thus creating a situation in which the gas sale contract involved, at the time of trial and during the period in question was in affiliate contract. *See id.* at 875.

from the sale of the gas pursuant to the lessee's gas sale contracts.[28] The royalty owners claimed that the term "market price" as used in the lease's gas royalty clause, should be given meaning by reference to *current* prices in the area rather than in accordance with the sale proceeds for the gas.[29] The lessees contended that since gas could only be marketed under long-term contracts that fix the price of the gas sold, the "market price" of the gas meant the amount received for the gas, provided the lessee exercised good faith in marketing the gas.[30]

Noting that none of the royalty owners involved in the case had agreed to accept royalties on the basis of the price stipulated in the gas sale contracts, the Texas Supreme Court held that regardless of the economic realities inherent in the marketing of natural gas,[31]

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28. The United contract price was 3.5¢ per Mcf which was reduced to 2.3¢ per Mcf with the adoption of the Standard Gas Measurement Law in Texas. *Id.* at 870. Under gas sale contracts entered into in 1960 and 1962, other purchasers of gas from the field (Tennessee Gas Transmission Company and Alamo Gas Supply Company) were paying prices for this gas ranging from 13¢ to 17.24¢ per Mcf. *Id.* at 870. The lessee's own witness testified that most gas sale contracts entered into during the relevant period specified a price for this gas of 12¢ per Mcf., less compression costs, and another witness of the lessee placed that figure at 8¢ per Mcf. *See* Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 74 (Tex. Civ. App.—San Antonio 1966), *rev'd*, 429 S.W.2d 866 (Tex. 1968).

The precise terms of the royalty clause involved in *Vela* were as follows: (1) "To deliver to the credit of lessor, free of cost, in the pipe line to which lessee may connect its or his wells, the equal one-eighth part of all oil produced and saved from the leased premises." Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 870 (Tex. 1968); (2) "To pay to lessor, as royalty for gas from each well where gas only is found, while the same is being sold or used off of the premises, one-eighth of the market price at the wells of the amount so sold or used." Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 72 (Tex. Civ. App.—San Antonio 1966), *rev'd*, 429 S.W.2d 866 (Tex. 1968); and (3) "To pay to lessor as royalty for gas produced from any oil well and used by lessee for the manufacture of gasoline, one-eighth of the market value of such gas. If such gas is sold by lessee, then lessee agrees to pay lessor, as royalty, one-eighth of the net proceeds derived from the sale of said casinghead gas at the wells." Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 870 (Tex. 1968).

29. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d, 866, 870 (Tex. 1968).

30. *Id.* at 870.

31. Relying heavily upon, and quoting at length from, the Fifth Circuit's decision in *Foster*, the court adopted as its own an extended passage from *Foster* which, in part, states:

> When it made the gas sales contract, Atlantic took the calculated risk of that contract producing royalties satisfactory to the lease terms. The fact that increases in market prices have made the lease obligations financially burdensome is no defense. . . .
>
> Stripped of all the trimmings Atlantic's position is simply: We cannot comply. This is no answer. The lease calls for royalty based on the market price prevailing for the field where produced when run. The fact that the acertainment of future market price may be troublesome or that the royalty provisions are improvident and result in

the royalties to which the royalty owners were entitled depended solely upon a construction of the governing oil, gas, and mineral lease, wholly independent of the terms of the gas sale agreements.[32] The court further noted that the royalty clause of the *Vela* lease contained provisions specifying that in certain circumstances the amount of royalty on casinghead gas was to be determined by reference to the net proceeds received from its sale, and that the royalty on oil produced under the lease was payable in kind. The court concluded, therefore, that the parties knew how to provide for royalties payable on some basis other than market value and could have so provided with respect to the subject gas well gas had they desired to do so.[33] Instead, the parties to the lease:

> stipulated in plain terms that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. This clearly means the prevailing market price at the time of the sale or use. The gas which was marketed under the long-term contracts in this case was not "being sold" at the time the contracts were made but at the time of the delivery to the purchaser. [citation omitted] We agree with the Court of Civil Appeals, therefore, that the contract price for which the gas was sold by the lessee is not necessarily the market price within the meaning of the lease.[34]

> a financial loss to Atlantic "is not a web of the Court's weaving." Atlantic cannot expect the court to rewrite the lease to Atlantic's satisfaction.

Id. at 871 (quoting *Foster v. Atlantic Ref. Co.*, 329 F.2d 485, 489-90 (5th Cir. 1964)).

32. *Id.* at 870. The *Vela* court's reference to the fact that the royalty owners had not agreed to accept royalty on the basis of the price specified in the gas sale contract foreshadowed the contention advanced by lessees in some recent *Vela*-type litigation that the royalty owners had accepted royalty payments made pursuant to division orders executed by the royalty owners and, therefore, were estopped to assert any claim for additional royalties. See note 47 *infra* and accompanying text.

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

34. *Id.* at 871. Perhaps the most devastating aspect of the entire *Vela* decision, from a mineral lessee's standpoint, is the holding that gas sold under a long-term contract is sold not at the time the contract is made, but at the time of each separate delivery of gas to the purchaser. This statement, coupled with the holding that the applicable gas royalty standard contained in the lease referred to the market price prevailing *at the time of the sale*, requires a redetermination of market value of the subject gas, for royalty purposes, with each delivery of the gas. This theory was adopted again by the court in *Middleton*. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 244-46 (Tex. 1981). This theory, however, has not been universally accepted. *See* Pierce v. Texas Pac. Oil Co., 547 F.2d 519 (10th Cir. 1976); Apache Gas Prods. Corp. v. Oklahoma Tax Comm'n, 509 P.2d 109, 112-13 (Okla. 1973). The *Vela* court relied upon a single precedent, a 1926 Commission of Appeals decision, *Martin v. Amis*, 288 S.W. 431, 433 (Tex. Comm'n App. 1926, judgmt adopted) as its

Thus, *Vela* held that when the gas royalty clause of an oil, gas, and mineral lease is based upon a "market price" standard, the royalty owner is entitled to royalties based upon the market price of gas prevailing at the time the gas is physically delivered into its purchaser's pipeline and not upon the market price of the gas as determined at the time of the commitment of the gas under the contract pursuant to which the gas is sold.

The *Vela* court also addressed the matter of determining the precise market value of the gas in question. In this regard, the court held that the market price of gas is "to be determined by sales of gas comparable in time, quality and availability to marketing outlets,"[35] and stated that "the mathematical average of all prices paid in the field is not a final answer to the difficult problem of determining market price at any particular time."[36] After re-

authority for when gas is sold under a long-term contract, and it relied upon *Foster* for its conclusion that the "market price" of gas is to be determined by reference to the current market price as measured from time to time. There is genuine doubt concerning whether *Martin* stands for this proposition. Some believe *Martin* holds only that an "executed sale" rather than merely a "sale" of gas is effected by a mineral lessee under a long-term gas sale contract when it delivers such gas to the pipeline. This contention, of course, would justify a different construction of the word "sold" as used in the gas royalty clauses examined herein.

Moreover, in contexts other than those involving gas royalties, courts have held that the term "sold" may have a more flexible meaning that that accorded it in *Vela*. For example, some courts have held that the term may refer to the single point in time when the property involved is committed or dedicated to sale by the making of the contract of sale. *See* Travelers Ins. Co. v. Gibson, 133 Tex. 534, 539, 130 S.W.2d 1026, 1028 (1939); Seabrook Ind. School Dist. v. Brown, 195 S.W.2d 828, 830 (Tex. Civ. App.—Galveston 1946, writ ref'd). Applying this construction of the term in *Vela* would have resulted in a finding that the market price of the gas involved should be determined only as of the time when the gas was *committed* to be sold under the long-term contract, not periodically as the gas is physically delivered into the pipeline.

35. Texas Oil & Gas Corp. v. Vela 429 S.W.2d 866, 872 (Tex. 1968). The comparability test was "borrowed" by the *Vela* court from *Phillips Petroleum Co. v. Bynum*, 155 F.2d 196, 199 (5th Cir. 1946). For a good discussion of the *Vela* decision, and this area of the law generally, see Comment, *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*, 11 St. Mary's L.J. 502 (1979). The author, in suggesting that the *Vela* market value test should be redefined, indicates a belief that the portion of the test which relates to availability to market outlet is archaic, considering that today gas has little difficulty in reaching an available market outlet. *Id.* at 509. The author suggests that this aspect of the test could be used to differentiate between sales of gas on the basis of varying exploration and production costs. This portion of the test could also contemplate a comparison of gas sales on the basis of flowing pressure differentials and thus refer to such items as compression charge variances and other transportation costs. *Id.* at 509.

36. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 873 (Tex. 1968).

viewing the evidence, the court concluded that the testimony of the royalty owners' expert witness provided the necessary scintilla of evidence[37] to support the trial court's decision awarding the royalty owners a recovery based on their expert's market value determination.[38] This determination involved the calculation of "an average price" received for gas sold from the field during the period covered by the lawsuit and was accomplished by the division of the volumes of gas sold from each well in the field into the value received for this gas.[39] Significantly, the expert's "market value" testimony was corroborated by actual gas sales from wells in the field

37. This part of the appeal was submitted under a "no evidence" point of error. *Id.* at 869.

38. *Id.* at 869.

39. *Id.* at 872. The royalty owners' expert witness, however, did not take into account *all* sales of gas from the field in arriving at his "market price." He disregarded all sales of gas made under certain identified contracts because he considered them "too far out of line." *Id.* at 872. The prices on the twelve wells considered ranged from 13¢ to 17.24¢ per Mcf with the average price being 16.04¢ per Mcf which, when adjusted downward by 3¢ per Mcf to account for the low pressure of the gas involved, yielded a "market value" of 13.047¢ per Mcf. *See* Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 75 (Tex. Civ. App.—San Antonio 1966), *rev'd,* 429 S.W.2d 866 (Tex. 1968). The field involved, the Lopeno Field, located in Zapata County, Texas, encompassed three sands, the Upper Queen City, the 2700 foot Queen City, and the Wilcox. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 868-69 (Tex. 1968). The deduction for compression charges was made with respect to gas produced from the Upper Queen City sand due to its low pressure. *Id.* at 872.

The lessee objected to the testimony of the royalty owners' expert on several grounds, but the trial court overruled most of these objections, allowing them simply to be taken into account in assessing the weight to be accorded the testimony. Specifically, the lessees contended that the proffered testimony did not consider quality differences in the gas sold under the various contracts, or flowing pressure differentials in such gas, and did not consider that some of the gas to which the *Vela* gas was compared had been sold under a package deal involving large gas reserves, some of which were regulated by the FPC. The lessees also asserted there was no evidence of a demand for the *Vela* gas at the alleged "market price." Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 75 (Tex. Civ. App.—San Antonio 1966), *rev'd,* 429 S.W.2d 866 (Tex. 1968).

The witness recognized that the market price of gas may be affected by the type and quality of the gas, as well as its pressure, deliverability, and the size of available reserves. He testified, however, that the size of the reserves were not a significant factor in that case because pipelines had already been laid into the field and the remaining reserves of the *Vela* gas, though smaller than those with which they were compared, were still sufficiently large to justify a market. He further stated that there was no significant difference between the quality of the *Vela* gas and that to which he compared it because all of the gas was being commingled in the field pipelines and the end use of all such gas was the same. Finally, he testified that the deliverability of the *Vela* wells was better than average for the field and that the flowing pressure differential was neutralized by his allowance of 3¢ per Mcf reduction in market price allocable to higher compression charges for the *Vela* gas. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872-73 (Tex. 1968).

at comparable net prices.[40] On this basis, the court affirmed the judgment of the trial court, as reformed to be consistent with its opinion.[41] Although the *Vela* court accepted the proffered proof as adequate to support the judgment, it did not provide definitive standards for calculating the market price of gas which would be applicable in other circumstances,[42] thus opening the door to a veritable explosion of market value gas royalty litigation.

III. The Explosion of Market Value Gas Royalty Litigation

Although the *Vela* decision did not immediately generate much action by royalty owners,[43] its rendition ultimately caused an explosion of market value gas royalty litigation. The *Vela*-type cases fell into several categories. Some cases involved whether the market value portion or the proceeds portion of a lease's royalty clause applied,[44] others focused upon the nature of "comparable sales"[45] in connection with the proper method for calculating the market

40. *Id.* at 873. These actual sales were made at net prices ranging from 13.047¢ to 14.2¢ per Mcf.

41. Four justices joined in a forceful dissent stating that "since it appears that the royalty provision fails to state as of what time the 'market price' is to be determined, . . . we must look to common practices in the industry at the time the lease contract was made in 1933 to ascertain what was the intention of the parties with reference to this matter." *Id.* at 879 (Hamilton, J., dissenting). The dissent stated that long-term gas sale agreements constituted the only method of marketing gas at the time the *Vela* lease was executed and therefore it should be presumed that the parties to the lease contracted with that circumstance in mind. The dissent reasoned, therefore, that the parties knew that the term "market price," as used in the lease's royalty clause, necessarily meant the price prevailing for gas under a long-term contract at the time the lease was signed. *Id.* at 879 (Hamilton, J., dissenting). The dissent distinguished the *Foster* decision relied upon by the majority on the basis of the "when run" language contained in the royalty clause of the lease construed in that case. *Id.* at 879-80 (Hamilton, J., dissenting). See cases and material cited notes 22, 24, 25 *supra*.

42. It is apparent from the opinion that the court did not enthusiastically embrace the mathematical average price put forward by the royalty owners' expert as conclusive of market value. Indeed, it seems clear that the court relied heavily upon the evidence of corroborating sales to bolster this testimony. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 873 (Tex. 1968).

43. The lapse of time between the decision in *Vela* and the initiation of similar market value gas royalty suits is puzzling. Perhaps the potential economic impact of this type of action was not immediately perceived by the plaintiff's bar.

44. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981); Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

45. *See* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980); Hemus & Co. v. Hawkins, 452 F. Supp. 861 (S.D. Tex. 1978); First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783 (Tex. Civ. App.—El Paso 1980, writ granted).

value of the subject gas,[46] and yet others dealt with contentions of ratification or estoppel.[47]

A. *Does the Market Value Standard Apply?*

In analyzing the *Vela* decision and its impact upon the calculation of lessee royalty obligations, one must initially consider that the determination of gas royalty due under an oil, gas, and mineral lease is not necessarily a function of the market value of the gas produced under the lease. This matter rests in the first instance upon a proper construction of the gas royalty clause involved which may contain some basis other than market value for making such a determination. In an effort to avoid the market value gas royalty pitfalls of *Vela,* some lessees involved in litigation subsequent to that decision asserted that their gas royalty obligations were governed by the portion of their lease's royalty clause which specified that gas royalty be determined on the basis of the proceeds received from the sale of the gas and not its market value.[48] This issue became the focal point of *Butler v. Exxon Corp.*[49] and assumed a peripheral position in the decision of the court of civil appeals in *Exxon Corp. v. Middleton.*[50]

The *Butler* decision involved the construction of four mineral leases, three of which provided for the payment of royalties based upon the market value at the well of a certain fraction of the gas produced from the land and sold or used off the premises, and upon a certain fraction of the amount realized from the sale of gas

46. Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.); Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981); Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

47. Hemus & Co. v. Hawkins, 452 F. Supp. 861 (S.D. Tex. 1978); Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981); Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

48. *See generally* Hoffman, *Oil and Gas Royalty Problems—Current Issues and Answers,* SW. LEGAL FOUNDATION 31ST INST. ON OIL & GAS LAW & TAX. 211 (1980).

49. 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

50. 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981). This was the case selected by the Texas Supreme Court to serve as the vehicle for its attempt to clarify the application of its *Vela* decision. In the supreme court the issue of whether the sales of gas occurred "at the well" or "off the premises" assumed a more important position.

produced from the land and sold at the wells.[51] During the period in question, the gas had been delivered to the purchaser at the tailgate of the lessee's centralized separation, dehydration, and compression facility located off the leased premises.[52] The expert testimony offered in the case conflicted as to whether these facts rendered the *Butler* gas transactions sales "off the premises," subject to a royalty based upon the market value of the gas, or sales "at the well," subject to a royalty determination based on the proceeds received from the sale of the gas.[53]

The court, without engaging in detailed analysis, construed the royalty clause contained in the *Butler* leases to provide that the "market value" portion thereof applied to gas produced and used "off the premises" and also to gas produced and sold at places

51. The precise terms of the royalty clause contained in the three *Butler* leases essentially provided as follows:

> The royalties to be paid by Lessee are: (a) on oil, one-eighth of that produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipe line to which the wells may be connected; Lessee may from time to time purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase; (b) on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or for the extraction of gasoline or other product therefrom, the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale; . . . and (c) on all other minerals mined and marketed, 1/8 either in kind or value at the well or mine.

Butler v. Exxon Corp., 559 S.W.2d 410, 412 Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (emphasis added).

The fourth *Butler* lease contained a gas royalty clause which simply directed the lessee to pay as royalty "one-sixteenth of the market value at the well of all gas produced and saved from the leased premises." *Id.* at 412. The *Butler* court held that the construction of the latter clause was exactly controlled by *Vela. Id.* at 416.

52. *Id.* at 413.

53. The royalty owners' expert recognized there could be a sale of gas "at the well" even though delivery was made to the purchaser several hundred feet from the wellhead, but stated that sales off the leased premises, such as these, were not sales at the well. *Id.* at 413. Exxon's expert considered these sales to have been made "at the well," defining that term to mean "a sale in or near the wells as distinguished from [a] tailgate of a plant sale." *Id.* at 413. The term "plant," as used here, refers to a gas processing plant which is a facility where "wet gas," that is, gas containing volumes of natural gas liquids (propane, butane, natural gasoline, ethane, methane, etc.) is processed for the purpose of extracting those natural gas liquids from the gas stream. The liquids are then either sold collectively in a mixed form or fractionated into their respective component parts and thereafter sold as individual products. The "residue gas," that is, the gas stream which remains after the liquids have been extracted therefrom, is then sold with delivery usually taking place at the tailgate of the plant.

other than "at the well".[54] With regard to gas sold "at the well," the court held that the lease specified that the royalty was to be 1/8th of the amount realized from the sale of the gas.[55] In applying its construction of this royalty clause to the *Butler* sales, the court noted that the parties had not used mutually exclusive terms, such as "at the well" and "away from the well" or "on the premises" and "off the premises," in fixing the gas royalty obligations under the lease, thus implying that a sale "at the well" could still involve delivery "off the premises."[56] On the basis of this construction and the meaning assigned to the phrase "at the well" within the petroleum industry, the *Butler* court held that term "at the well," as used in the gas royalty clauses before it, meant deliveries of gas occurring in the vicinity of the field of production where the specific wells were located, rather than at some remote location such as the other end of a gas transmission line. The court then noted that, although made off the leased premises, the *Butler* gas sales were consummated near the wells and within the field of production and, therfore, constituted sales "at the wells,"[57] so that no additional royalty was due with respect to them.

In *Middleton*, the Houston Court of Civil Appeals for the Fourteenth District faced a similar issue in construing the same royalty clause, but concluded that the market value portion of the gas royalty clause applied. Part of the gas involved had been processed at the lessee's gas processing plant located away from the leased premises and had been delivered to the gas purchaser at the tailgate of the plant.[58] The lessee had paid royalties with respect to this gas on the basis of the proceeds received from the sale of the

54. *Id.* at 416.

55. *Id.* at 416.

56. *Id.* at 416.

57. *Id.* at 415-16. A similar result was reached in *Skaggs v. Heard*, 172 F. Supp. 813, 817 (S.D. Tex. 1959). The *Butler* court further stated that "for a sale to be termed 'at the wells', delivery need not occur at the 'Christmas tree' on top of the well casing, nor is there any requirement that delivery occur on the particular lease or unit from which the gas is produced." Butler v. Exxon Corp. 559 S.W.2d 410, 414 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). This part of the court's holding ultimately was disapproved by the Texas Supreme Court in its *Middleton* decision. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex. 1981). The term "Christmas tree" refers to "[t]he assembly of valves, pipes and fittings used to control the flow of production from the casinghead" of a well. H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 82 (1978).

58. Exxon Corp. v. Middleton, 571 S.W.2d 349, 363 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981).

gas. The court of civil appeals, however, affirming the trial court's judgment, held that this gas was sold as it was delivered and that because such sales occurred "off the premises," the market value portion of the gas royalty clause was applicable.[59] As a result, the court of civil appeals held the lessee liable for the difference between the amount of royalties paid on this gas and the amount of royalties calculable on the basis of the market value of this gas.

Thus, prior to the supreme court's decision in *Middleton*, it appeared, somewhat inconsistently, that sales of gas made at the lessee's own central delivery facilities located off the leased premises constituted sales of gas "at the well" and, depending upon the language of the applicable gas royalty clause, were not subject to *Vela's* market value royalty determination, whereas sales of gas at the tailgate of a processing plant located off the lease were sales "off the premises" and subject to *Vela's* market value royalty test.[60] In all cases, however, it seemed that sales of gas made anywhere on the lease constituted sales "at the well" and qualified for "proceeds" royalty treatment.

B. *What Are Comparable Sales?*

Under the test announced in *Vela*, the market price of gas for

59. *Id.* at 364 (by implication).

60. Some analysts considered the decisions in *Butler* and *Middleton* to be "squarely in conflict as to the proper interpretation of the phrases 'off the premises' and 'at the wells'." Hemingway, *Oil And Gas, Annual Survey of Texas Law*, 33 Sw. L.J. 185, 191 (1979). However, the decisions arguably are distinguishable on the basis of the expert testimony offered in each case and, in this respect, are consistent, if not clearly so. *Butler* presented a situation involving sales of gas at a central separation and compression facility; *Middleton* involved sales of gas at a processing plant's tailgate. In both cases, of course, the deliveries were made away from the leased premises. These elements, without more, would simply amount to distinctions and not genuine differences. The differentiating feature of these cases, however, rests with testimony offered by the *Butler* lessee's expert witness who stated that "a well head sale is generally considered to be a sale in or near the wells *as distinguished from tailgate of a plant sale*" and characterized the *Butler* sales as wellhead sales. Butler v. Exxon Corp., 559 S.W.2d 410, 413 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (emphasis added). Thus, if the *Butler* court had decided *Middleton* on the basis of this expert testimony (which obviously supplied the basis for the *Butler* decision), the court could have reached the same result the *Middleton* court did on the basis that the *Middleton* facts presented a plant tailgate sale of royalty gas and, therefore, constituted a sale "off the premises."

For a case which discusses the differing effects of a proceeds gas royalty clause and a market value gas royalty clause, see Lightcap v. Mobil Oil Corp., 562 P.2d 1 (Kan. 1977). In *Lightcap*, however, there was no dispute that the sales involved occurred at the wells.

royalty purposes is to be determined by reference to sales of gas "comparable in time, quality and availability to marketing outlets."[61] The issue of whether particular sales of gas are comparable sales within the meaning of the *Vela* test may arise in several contexts;[62] however, the issue of comparability has been litigated al-

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61. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872-73 (Tex. 1968).

62. Some of these contexts included disputes based upon the quality differentials of the gas, quantity differentials in the sales of gas, the regulated or unregulated nature of the sale, and so forth. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981). The following passage, quoted from the United States District Court's opinion in *Brent v. Natural Gas Pipeline Co. of America,* discusses several circumstances which may bear upon the comparability issue, a difference in any one of which could render one sale non-comparable to another:

> The opinions given by plaintiffs' expert witnesses must be rejected for two reasons. First, said opinions take into consideration both sales of intrastate and interstate gas in determining "market value." Secondly, it was shown that many of the interstate gas sales contracts examined and considered by plaintiffs' witnesses reflected prices which were short term or emergency sales prices, small producer prices, prices allowed for newly discovered gas and prices which were rolled back to the FPC rate. Under the facts of this case involving vintage gas, a large producer, and where no special exceptions were shown to exist which would support a petition by either plaintiffs or defendant to FPC for higher rates, the court is of the opinion that many of the interstate sales contracts, upon which plaintiffs' market value opinion is based, are not comparable to determine market value.

Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 676 F.2d 1261 (5th Cir. 1980).

Another item which at least one court has stated affects comparability is the matter of daily deliverability. In this regard, the court in *First Nat'l Bank in Weatherford v. Exxon Corp.,* in holding that the royalty owner involved had failed to prove the market value of the gas in question because its proof involved an averaging of interstate and intrastate gas sales (which the court held were non-comparable sales), stated:

> Appellant's evidence fails in another area. Its cause of action is for value as though the gas were sold when run from day to day. [citation omitted]. Appellant offered no evidence of any gas which was sold on a day by day basis; its evidence was from contract sales and there was no evidence of lessees or producers selling their gas in open market or on a day to day basis. Appellant seeks recovery for the gas sold in that manner, but offers no evidence of what gas would bring when marketed in that manner.

First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783, 786 (Tex. Civ. App.—El Paso 1977, writ granted).

This portion of the *Weatherford* court's decision seems to suggest that only sales of gas on the "spot market" would be comparable sales for one seeking to assert a *Vela* claim. Such a position seems open to criticism. In part, *Vela* held that gas committed to long-term contracts is sold whenever a delivery of the gas is made to the purchaser. *See* Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968). Since all gas being sold is customarily delivered every day, under *Vela* such gas is sold every day whether it is sold on the "spot market" or under a long-term contract. Thus, it seems inconceivable that there is any gas *not* sold on a daily basis under the *Vela* rationale. Since the royalty owner in *Weatherford* most exclusively over whether sales of gas in the intrastate and interstate markets constitute comparable sales of gas. This issue was addressed directly in *Middleton, First National Bank in Weatherford v. Exxon Corp.,*[63] *Hemus & Co. v. Hawkins,*[64] *Kingery v. Continental Oil Co.,*[65] and, by implication, in *Exxon Corp. v. Jefferson Land Co.*[66]

In *Middleton,* the sales to be valued were sales made in intrastate commerce. The lessee, Exxon Corporation (Exxon), in providing a market price valuation for this gas proposed to take into account sales of gas made in interstate commerce from the same field, with their accompanying lower prices. These interstate sales had been included by Exxon in calculating its "field price", which, according to Exxon, was conclusive of the market value of the subject gas. Briefly, Exxon's "field price" is a weighted average price derived by reference to the weighted average price of all sales of gas in an area composed of Texas Railroad Commission District 3 and seven adjoining counties.[67] The court of civil appeals in *Middleton,* however, rejected the use of Exxon's "field price" for market price valuation of the subject intrastate gas because the price of the interstate sales involved in the calculation of the field price was a regulated price fixed by the Federal Power Commission (FPC) and, therefore, not indicative of the actual market value of the unregulated intrastate gas sales involved.[68] On this basis, the court held that interstate sales were not comparable sales to those made in the intrastate market. Since the sales in interstate com-

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presented evidence of allegedly comparable sales (albeit intrastate rather than interstate sales), under *Vela* the *Weatherford* court had evidence of "daily gas sales" before it. Thus, this part of the *Weatherford* court's reasoning seems curious.

63. 597 S.W.2d 783 (Tex. Civ. App.—El Paso 1980, writ granted).

64. 452 F. Supp. 861 (S.D. Tex. 1978).

65. 626 F.2d 1261 (5th Cir. 1980).

66. 573 S.W.2d 829 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.).

67. Exxon divides the *total* price reported as paid for one month in each quarter of the year for the gas delivered to major purchasers in that marketing area by the *total* volume of gas delivered in that area to those purchasers during that time. The quotient yields a volume-weighted average price for most of the gas sold in that area for a period of time two or three months before the time for which Exxon is attempting to set its field price. From that volume-weighted average price Exxon projects the current weighted average field price and pays royalty on the basis of that projected weighted average price. Exxon Corp. v. Middleton, 571 S.W.2d 349, 356 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981).

68. *Id.* at 362.

merce included in Exxon's "field price" were considered by the court not to be comparable to the intrastate gas sales in question, Exxon's "field price" was held not to be an accurate reflection of the market value of the subject gas.[69]

In contrast to *Middleton,* the *Jefferson Land Co.* decision *approved* the use of Exxon's "field price" for purposes of fixing the market value royalty of gas sold in intrastate commerce, subject only to the exclusion of all sales of gas made under pre-1973 gas sale contracts. *Jefferson Land Co.* involved the interpretation of a royalty clause which required the payment, as royalty, to the royalty owners of "the market value at the well of one-eighth (⅛) of the gas so sold or used."[70] The issue before the court was the same as that presented in *Middleton*: whether the market value of purely intrastate sales of gas could be determined by reference to Exxon's "field price," which was calculated by taking into account both interstate and intrastate sales of gas from the field in question.[71]

Reaching a result diametrically opposed to the *Middleton* decision, the *Jefferson Land Co.* court summarily held that Exxon's "field price" for all gas sold by all producers in the particular area was a proper method of determining the market value of the intrastate gas. The court did, however, limit the gas sales that could be included in Exxon's "field price" calculation to those sales made pursuant to contracts entered into after January 1, 1973,[72] reason-

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69. *Id.* at 362. In the precise words of the court:

> We overrule Exxon's contention that its "field price" is the appropriate measure of the market value of the gas produced from appellees' leases in 1973, 1974 and 1975. Exxon's field price is computed, in part, on the basis of sales of gas in interstate commerce. The price of gas sold in interstate commerce during 1973, 1974 and 1975 was regulated by the Federal Power Commission. [citation omitted]. Frederick M. Perkins, Exxon's vice-president for production, testified that the price set by the FPC on gas sold in interstate markets was lower than the price the gas would bring if sold in intrastate markets in Texas. The parties have stipulated that, at all times material to this dispute, all of the gas produced from wells located on the appellees' leases was sold in intrastate markets in Texas. Exxon's field price, therefore, is based on sales of gas that are not comparable to sales of gas produced from wells located on the appellees' leases, and may not be an accurate reflection of the market value of that gas.

Id. at 362-63.

70. Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 830 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.).

71. *See id.* at 831. This was the same field price calculation that was involved in the *Middleton* case.

72. *Id.* at 831.

ing that the gas sold under contracts made prior to that date was sold at prices reflecting the low market value of gas during that period, and if those sales were included in the present market value determination, the resulting market value would be depressed to an artificially low level.[73] Thus, the ultimate holding of the *Jefferson Land Co.* court was that Exxon's "field price," calculated by reference to all sales of all gas produced from the field (even gas committed to the regulated interstate market) and sold pursuant to gas sale contracts entered into after January 1, 1973, constituted the market price of the unregulated intrastate gas involved.

This aspect of comparability was also raised in a context which presented the opposite circumstances from those involved in *Middleton* and *Jefferson Land Co.* In *Kingery v. Continental Oil Co.*,[74] *Hemus & Co. v. Hawkins*,[75] and *First National Bank in Weatherford v. Exxon Corp.*,[76] the lessors proposed to value the subject sales of interstate gas by reference to higher priced sales of intrastate gas, not the lower priced interstate gas. In this manner, the lessors sought to boost the market price of the gas involved, thereby increasing the dollar amount allocable to the fractional royalty to which they claimed to be entitled. In each instance, however, the court held that sales of gas in the unregulated intrastate market were not comparable to sales of gas in the regulated interstate market.

In *Kingery*, the Fifth Circuit consolidated three conflicting district court decisions[77] which dealt with this issue in similar factual contexts. In each case the royalty owner brought a *Vela* claim with regard to gas produced from the respective leased premises and sold in interstate commerce under a certificate of convenience and necessity issued by the FPC. In each case the lessee had paid royalty on such gas based upon the sales price charged and received

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73. *Id.* at 831.

74. 626 F.2d 1261 (5th Cir. 1980).

75. 452 F. Supp. 861 (S.D. Tex. 1978).

76. 597 S.W.2d 783 (Tex. Civ. App.—El Paso 1980, writ granted).

77. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155 (N.D. Tex. 1978); Hawley v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155 (N.D. Tex. 1978); Kingery v. Continental Oil Co., 434 F. Supp. 349 (W.D. Tex. 1977). Because the issues and facts in these cases were essentially identical, the Fifth Circuit consolidated their appeals. *See* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980). *Brent* and *Hawley* previously had been consolidated in the United States District Court.

for the gas in the interstate market.[78] In two cases,[79] the trial court held that intrastate (unregulated) sales were not comparable to interstate (regulated) sales and that the market value of the subject gas should be determined solely on the basis of recent sales of comparable gas made in the interstate market.[80] In the third case,[81] however, the trial court made no distinction between interstate and intrastate markets, simply holding that the market value of the gas involved should be established by evidence of gas sales and negotiations for gas sales in the immediate area during the relevant years.[82]

The Fifth Circuit reversed the latter decision and affirmed the

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78. *See* Kingery v. Continental Oil Co., 626 F.2d 1261, 1262 (5th Cir. 1980). The *Brent* and *Hawley* cases involved the determination of royalty payable under gas leases covering land situated in Moore County, Texas, which had been executed in the 1920's and which contained clauses specifying that the royalty should be paid on the basis of "the market value at the well of one-eighth (1/8) of the gas produced, saved, and sold or used off the leased premises." *Id.* at 1262. The *Kingery* case involved the same kind of determination under a 1944 oil, gas, and mineral lease covering land located in Live Oak County, Texas, which provided for gas royalty to be paid pursuant to a royalty clause identical to that involved in *Middleton. Id.* at 1263. *Compare* Kingery v. Continental Oil Co., 626 F.2d 1261, 1263 (5th Cir. 1980) *with* Exxon Corp. v. Middleton, 571 S.W.2d 349, 353 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981). The *Kingery* royalty clause, therefore, required that the royalty owners contend that the subject gas sales had occurred "off the premises" rather than "at the well" in order to properly assert that a market value determination with respect to this gas was necessary.

The United States District Court in *Kingery* agreed with the royalty owners that their gas had been sold "off the premises" and held that royalty should have been paid on the basis of the gas market value. The *Brent* and *Hawley* royalty clauses did not raise this issue. The Fifth Circuit did not reach the issue of lease construction raised in *Brent* and *Hawley* because of its decision with respect to the market value evidence.

79. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155 (N.D. Tex. 1978); Hawley v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155 (N.D. Tex. 1978). These cases were heard together before the United States District Court and combined in one opinion.

80. The court further held that such market value was identical to the Federal Energy Regulatory Commission (FERC) (the regulatory successor to FPC) ceiling price because all comparable gas in the area was being sold at such ceiling price. Because the subject gas had been sold at that ceiling price (its market value), the court denied the royalty owners any recovery. *See* Kingery v. Continental Oil Co., 626 F.2d 1261, 1263 (5th Cir. 1980). The Fifth Circuit expressly withheld opinion on this conclusion by the United States District Court. *See id.* at 1265.

81. Kingery v. Continental Oil Co., 434 F. Supp. 349 (W.D. Tex. 1977), *rev'd,* 626 F.2d 1261 (5th Cir. 1980).

82. The royalty owners' expert witnesses made no attempt to include interstate sales in their market value testimony, basing their opinion solely upon area sales of otherwise comparable gas made in the intrastate market. *See* Kingery v. Continental Oil Co., 626 F.2d 1261, 1263 (5th Cir. 1980).

former two holding that "where the gas has been irrevocably dedicated to the interstate market, it follows inexorably that the only comparable sales to be used in determining the market value of such gas are sales on the interstate market."[83] The two types of gas markets were not comparable, the court stated, because interstate gas could not be sold on the intrastate market. The gas, therefore, had no value on the intrastate market according to the court, because persons contracting for the sale of interstate gas could not lawfully specify a price for such gas in excess of that allowed by federal regulations, such as the higher intrastate gas price.[84] Thus, the prices charged in these two forms of sale were clearly non-comparable. The court limited its decision to this holding, however, expressly refusing to state that the sales price of the interstate gas involved was conclusive of its market value.[85]

Hemus and *Weatherford* also squarely addressed the comparability of interstate and intrastate gas markets. The *Hemus* court, writing prior to the Fifth Circuit's decision in *Kingery*, anticipated the Fifth Circuit's decision. Phrasing the issue as being "[w]hat sales are properly considered comparable in determining the 'market value' of gas dedicated to interstate commerce?",[86] the *Hemus* court unequivocally concluded that for the purpose of determining the market value of interstate gas as the basis for royalty payments, "interstate sales [of gas] are comparable but intrastate sales are not."[87]

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83. *Id.* at 1264. The court correspondingly stated that "sales on the intrastate market are not comparable in determining the market value of such gas." *Id.* at 1264. It should be noted, however, that there is a motion for rehearing pending before the Fifth Circuit. By letter dated May 11, 1981, all counsel of record were notified that the court would not act on the petitions for rehearing until the Texas Supreme Court decides *Weatherford.*

84. *Id.* at 1264.

85. *Id.* at 1264 n.3. The court distinguished *J. M. Huber Corp. v. Denman*, 367 F.2d 104 (5th Cir. 1966) on this basis. See cases and materials cited note 26 *supra*. The court, in withholding opinion on this point, must have been contemplating a situation where the actual market price of interstate gas would be below the regulated ceiling price.

86. Hemus & Co. v. Hawkins, 452 F. Supp. 861, 861-62 (S.D. Tex. 1978). *Hemus* involved the construction of a 1961 lease, the production from which was sold and dedicated to interstate commerce. The royalty owners' expert predicated his market value testimony upon "comparable" sales in the intrastate market. The lessee's expert rendered alternative opinions on the market value of this gas—one based solely on interstate sales of comparable gas and the other premised upon a weighted average of the prevailing prices in *all* current sales (regulated and unregulated) in the market area. *Id.* at 862.

87. *Id.* at 862. The court considered the case to be controlled entirely by *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966). See cases and material cited note

The *Weatherford* court was the first Texas appellate court required to determine the market value of gas sold in the interstate market. In *Weatherford,* it was undisputed that the gas had been irrevocably dedicated to the regulated interstate market and that the royalty payable thereon was calculable on the basis of the market value of the gas.[88] The royalty owners attempted, however, by reference to gas sold in intrastate commerce, to establish a higher market value for the subject gas than that on which their royalty had been paid. As the *Hemus* court before it, and the *Kingery* court after it, the *Weatherford* court rejected the notion that a sale in the intrastate market is comparable to a sale in the interstate market, reasoning that "[s]ales in [the] intrastate market were based on what willing buyers and willing sellers agreed to, while sellers and buyers of [the subject] gas could not contract for a price above that allowed by federal regulation. Evidence of a price arrived at above the federally regulated price would not be admissible as comparable."[89]

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26 *supra.* In this regard, the *Hemus* court quoted and adopted the following test articulated in *Weymouth* as being applicable to determine the market value of gas dedicated to interstate commerce:

> What 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?

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

88. The dedication of this gas to interstate commerce had been accomplished under an FPC approved 25-year gas contract executed in 1967. There were two leases involved, both with nearly identical gas royalty provisions which essentially ordered the lessee to deliver, in kind to the lessor 3/32ds of all the oil and gas produced and saved from the lease or to pay to the lessor 3/32ds of the value of all oil and gas produced and saved from the lease. *See* First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783, 785 (Tex. Civ. App.—El Paso 1980, writ granted).

89. *Id.* at 786. The royalty owners suggested fixing a theoretical market value by reference to intrastate sales. The *Weatherford* court had little difficulty in finding that since the lawsuit presented a request for an actual, not theoretical, money award, and an actual, not theoretical, determination of royalty rights, its decision should be based upon an actual, not theoretical, market value. *Id.* at 786. Interestingly, the court, in rejecting the royalty owner's alternative offer of evidence of other gas sales within the regulated market as comparable sales, suggested there can be no comparable sales within the regulated market because, apparently referring to the terms of the Natural Gas Policy Act of 1978, Pub. 6. 95-621, 92 Stat. 3350 (1978), "the regulating agency classifies and divides the gas into various categories and fixes the price for each category. With all prices fixed, we fail to see how one could be comparable to the other to make either the 'market value'." First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783, 785 (Tex. Civ. App.—El Paso 1980, writ granted).

Thus, immediately prior to the Texas Supreme Court's decision in *Exxon v. Middleton* all but one decision applying Texas law had reached the same result on this aspect of comparability, holding that interstate and intrastate gas sales are not comparable sales in applying the *Vela* test to establish the market value of gas for royalty calculation purposes.

C. *Determining the Market Value of Gas.*

In those instances in which courts held that the market value royalty standard governed the determination of the proper amount of gas royalty payable under oil, gas, and mineral leases, either because the royalty clause provided no alternative basis for such payment or because the alternative bases were inapplicable, the courts were required to determine correctly the market value of the gas involved. The *Vela* opinion was of little help in making this determination because although it stated that the market price of gas is to be established by sales of gas comparable in time, quality, and availability to marketing outlets,[90] it did not prescribe specific standards by which other courts could assess the comparability of gas sales.[91] As a result, *Vela*, and subsequent decisions which purported to follow *Vela*, exhibited a variety of methods for calculating the market value of gas.

One of the criteria of comparable sales contemplated by the *Vela* test is that they occur in the same market area. Most courts faced with post-*Vela* market value gas royalty determinations initially attempted to define the market area, thereby limiting the number of "comparable sales" to be considered.[92] In *Vela*, the issue of rele-

90. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872-73 (Tex. 1968).

91. The *Vela* court simply affirmed the use, *in that particular instance*, of a market value determination premised upon a mathematical average of the prices at which all gas produced from the field involved was sold during the four-year period in question. The court certainly did not prescribe such a "mathematical average" formula for use in making market value determinations. In fact, the affirmance of this method appears to have been based heavily on the fact that actual sales of gas from this field recently had been made at prices closely approximating the calculated market price, thus corroborating the efficacy of that market value determination. *See id.* at 873. That the *Vela* court clearly was not enamored with this "mathematical average field price" method, is shown by its statement that such a calculation "is not a final answer to the difficult problem of determining market price" of gas committed to a long-term sale agreement. *Id.* at 873. Thus, the *Vela* case provided little, if any, guidance to other courts facing the issue of market value determination.

92. Hoffman, *Oil and Gas Royalty Problems—Current Issues and Answers*, SW. LEGAL

vant market area was not raised, all parties conceding *sub silentio* that the field constituted the appropriate market area.[93] Nevertheless, the *Vela* court, in dicta, warned that an "average of all prices paid *in the field* is not a final answer to the difficult problem of determining market price."[94] Despite this warning, two intermediate appellate courts addressing this issue in the wake of *Vela* adopted the concept that the field is the proper market area upon which to base a market value gas royalty determination.[95]

In *Butler*, the royalty owners' expert witness initially attempted to show that the market area for the gas involved covered a seven-county area of South Texas, but ultimately based his conclusion with respect to the market value of the gas on "comparable" sales which occurred in two of those seven counties during the period covered by this suit.[96] In reversing and remanding, the *Butler* court said that because the conclusions of the royalty owners' expert had not been refuted, the trial court could apply them in determining the royalty due. The court also noted, however, that "an actual market *in the field* will be practically conclusive evidence of value."[97] Thus, the *Butler* court, while approving the use of a two county market area in the circumstance before it, seemed to indicate that the field, given the appropriate circumstances, will constitute the relevant market area as a matter of law, unless there are no comparable sales of gas being made from the field.

Similarly, in the court of civil appeals' decision in *Middleton*, the royalty owners' expert witness selected as the relevant market area all of Texas Railroad Commission Districts 2, 3, and 4, which comprise a large part of the gas-producing area of South Texas,

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FOUNDATION 31ST INST. ON OIL & GAS LAW & TAX. 211, 219-21 (1980).

93. This is implicit in the decision's failure to note any conflicting testimony or argument on this issue.

94. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 873 (Tex. 1968) (emphasis added).

95. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App—Houston [14th Dist.] 1978), *rev'd*, 613 S.W. 2d 240 (Tex. 1981); Butler v. Exxon Corp., 559 S.W.2d 410, 413 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

96. *See* Butler v. Exxon Corp., 559 S.W.2d 410, 413 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). The field involved here was the Atkinson Field. The ultimate conclusion of the royalty owners' expert as to the market value of gas produced from the field was the result of averaging the three highest priced sales in Live Oak and Karnes Counties which occurred during the first month of each quarter during the period involved. The prices of the gas in these sales ranged from 32.9¢ per Mcf to $2.06 per Mcf. *Id.* at 413. The testimony of the lessee's expert concerning market value, if any, is not reflected in the court's opinion.

97. *Id.* at 417 n.2.

and calculated the market value of the gas in question by averaging the three highest prices in that area during the first month of each calendar quarter of the years covered by the suit.[98] The court held that this method of determining market value did not meet the requirements of *Vela* because, among other things, "the relevant marketing area is the field in which the gas was produced,"[99] and the witness had ranged far beyond that field in his search for higher prices.

By comparison, the court in *Jefferson Land Co.* held that the appropriate market area for determining the market value of gas was all of Texas Railroad Commission District 3, plus seven other adjoining counties.[100] The court, however, stated its conclusion without discussion, and it is not clear from the opinion whether the matter of market area was contested. Likewise, the district court decisions in *Kingery* and *Brent,* both of which were superseded on appeal,[101] made casual reference to the matter of market area, but did so in terms so vague as to suggest that the issue was not raised seriously. The *Kingery* district court opinion described the relevant market area as being "the immediate vicinity"[102] of the lease, while the *Brent* district court decision referred to the market area as being "the geographical area in which the wells producing such gas were located."[103] No other *Vela*-type case addressed this issue.[104]

98. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 357-58 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981). The field involved here was the Anahuac Field and the geographical area covered by these Railroad Commisson Districts extended from Kleberg County through the Gulf Coast into East Texas. *Id.* at 357. Exxon, the lessee, contended that the true market price was equal to the Exxon "field price" which was based on a market area covering the Anahuac Field and seven adjoining counties. *Id.* at 355-56.

99. *Id.* at 362. Thus, the court, in limiting the market area to just the field, disagreed both with Exxon's concept of the bounds of the relevant market area and the royalty owners' notion of the correct market area and the royalty owners' notion of the correct market area.

100. Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.— Beaumont 1978, writ ref'd n.r.e.). This, of course, was precisely the market area which Exxon used to calculate its "field price" and was the standard the *Butler* court rejected.

101. *See* Kingery v. Continental Oil Co., 626 F.2d 1261, 1265-66 (5th Cir. 1980).

102. Kingery v. Continental Oil Co., 434 F. Supp. 349, 351 (W.D. Tex. 1977), *rev'd,* 626 F.2d 1261 (5th Cir. 1980).

103. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980).

104. This issue was not discussed or even mentioned on appeal in *Kingery, Hemus,* or *Weatherford.*

Thus, as with the matter of comparability, the market value gas royalty decisions rendered prior to the Texas Supreme Court's decision in *Middleton* conflicted concerning what constitutes the relevant market area for the purpose of fixing the market value of gas involved in *Vela*-type claims.

The computational methods for determining the market value of gas employed by the courts in rendering post-*Vela*, pre-*Middleton* decisions concerning the market value of gas committed to long-term sale contracts were similarly at variance with each other. Here again, the *Vela* decision did not provide much guidance for the courts.[105]

The computational method presented in *Vela* consisted of a mathematical average of the prices at which all gas produced from the field was sold during the relevant time. Excluded from these calculations were sales which the testifying expert considered "too far out of line."[106] This method was accepted by the *Vela* court as appropriate in that case, principally because the market price produced by this method had been corroborated by recent actual sales of gas from the field.[107] The *Vela* court, however, expressly declined to adopt this method as a standard for courts to follow in rendering future market value gas royalty decisions.[108] As a result, courts attempting to follow and apply *Vela's* test in computing the market value of the gas involved in their own particular circumstances were left to their own devices. This was reflected in the lack of consistency, and in some instances the lack of analysis, shown in the decisions. The inconsistency of the post-*Vela* decisions in this area is especially apparent in the cases dealing with the valuation of intrastate gas. For example, in *Jefferson Land Co.* the court expressly approved the use of the Exxon "field price" method for calculating the market value of gas committed to be sold under a long-term contract, while the identical method was expressly rejected for this purpose by the *Middleton* civil appeals court. The Exxon "field price" is determined by dividing the total price reported as paid for one month in each quarter of the year for gas delivered to major purchasers in a market area consisting of

105. See cases and material cited note 91 *supra*.
106. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872 (Tex. 1968).
107. *See id.* at 873.
108. *See id.* at 873.

Texas Railroad Commission District 3 and seven adjoining counties, by the total volume of gas delivered to those purchasers in that area and during that time. The resulting quotient constitutes a volume weighted average price for the gas sold in that area during the two or three months before the period for which Exxon seeks to determine its field price. Exxon projects its *current* weighted average field price from this latter calculation and pays royalty on the basis of that projected weighted average price.[109]

As previously discussed, the *Jefferson Land Co.* court accepted this computational method without analyzing its effect, slightly modifying it to require that the method exclude prices paid under pre-1973 gas sale agreements because the prices fixed thereunder were too low to reflect the rapid escalation of gas prices experienced in 1973, 1974, and 1975.[110] The court of civil appeals in *Middleton*, on the other hand, rejected the use of the Exxon "field price" because its methodology required the inclusion of non-comparable gas sales in determining the market value of the subject gas.[111] Thus, the absence of a clear directive from the *Vela* court

109. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 356 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981); Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.).

110. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.). See notes 70-73 *supra* and accompanying text. In the process, the appellate court reversed the trial court's judgment concerning market value because the evidence was factually insufficient to support the values found by the lower court. Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 830 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.). The trial court had rejected the opinions of all the expert witnesses in the case and entered judgment for the royalty owners upon values which did not correspond with the testimony of any witness. *Id.* at 830. Both sides challenged those value findings as constituting an attempt "to split the difference" between the value figures offered by each side. *Id.* at 830 n.1.

111. Exxon Corp. v. Middleton, 571 S.W.2d 349, 362 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981). See notes 67-89 *supra* and accompanying text. The court stated that its holding was further supported by Exxon's own method of computing market value for gas produced from reservoirs discovered by drilling after January 1, 1972. With regard to such new vintage gas, Exxon, rather than using its "field price" method, assigns the gas a market value, for royalty purposes, by computing an arithmetic average of the three highest prices paid by a pipeline in sales of more than one million cubic feet of gas per day in the geographical area covered by Texas Railroad Commisson Districts 1-6, adjusted to reflect the heating capacity of that gas. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 363 (Tex. Civ. App.—Houston [14th Dist] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981). The court also noted the similarity between this method of assigning market value to gas and that used by the royalty owners' expert. *Id.* at 363. For a discussion of this latter method, see notes 114-123 *infra* and accompanying text.

concerning the proper method to be used in calculating the market value of gas involved in this type of royalty claim produced directly conflicting results in *Jefferson Land Co.* and *Middleton.*

Another method suggested in post-*Vela* litigation[112] as being appropriate for determining the market value of gas committed for sale in the intrastate market under a long-term contract used as the comparable marketing area Texas Railroad Commission Districts 2, 3, and 4[113] and calculated market value of the subject gas by averaging the three *highest* prices paid[114] in that area during the first month of each quarter of the period covered by the lawsuit. In making this calculation, all sales to transmission companies[115] or to affiliates of the purchaser of the gas were excluded, as were prices paid which were not reported to the State Comptroller's Office.[116]

This computational method was analyzed in depth by the *Middleton* court and found unacceptable. The court agreed that transmission company sales should be excluded from any calculation of the market value of gas on the ground that those sale prices often include large transmission charges, rather than being limited to consideration for the gas itself. The court also agreed with the exclusion of sales in which the seller and purchaser were affiliates because of the risk that those sales might not be arm's-length transactions.[117] The court, however, criticized the proffered method

112. *See* Exxon Corp. v. Middleton 571 S.W.2d 349, 362 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981).

113. For discussion of the comparable marketing area concept, see notes 92-104 *supra* and accompanying text. The *Middleton* case is discussed in connection therewith at notes 98-99 *supra* and accompanying text.

114. The three highest prices in the given area were paid on the basis of the "Btu" content of the gas. This term is an abbreviation or acronym for the words "British thermal unit" which refers to the amount of heat needed to raise the temperature of one pound of water one degree Farenheit. Under this principle, "dry gas," that is gas with a small natural gas liquid content, has an energy value of approximately 1031 Btu per cubic foot at standard temperature pressure while "wet gas," that is, gas having a large natural gas liquid content, has a corresponding value of 1103 Btu per cubic foot at standard temperature pressure. H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 57-58 (1978).

115. "Transmission companies" are those which transmit gas, usually by means of an elaborate network of pipelines, valves, meters, boosters, tanks, and compressors, from a processing plant, storage area, gathering system, or other wholesale source to one or more distribution areas such as cities or industrial plants. *Id.* at 612-13.

116. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 358 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981).

117. *See id.* at 358. The blanket exclusion of all affiliate sales is subject to criticism.

for a variety of reasons including: (1) it did not limit the relevant market area to the field[118] nor did it give any weight to sales made from the field; (2) it did not demonstrate that the sales taken into account were comparable to those of the subject gas in terms of time, quality, and availability to market outlet;[119] (3) it utilized only the three highest prices paid for gas committed in long-term contracts in the selected market area;[120] (4) it made no mathematical average of all prices in the field;[121] (5) it was not corroborated by actual, comparable sales;[122] and (6) its calculations were based on data compiled quarterly rather than monthly, a method inconsistent with the time period at issue in the case.[123]

The *Butler* case, another decision dealing with intrastate gas, did not address the proper method for calculating the market value of gas in any depth. Without benefit of analysis, the court expressly disapproved of calculating the market value of gas com-

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Obviously such sales must be carefully examined to ensure that they have been made at arm's-length. However, if such sales are reasonably priced in relation to other non-affiliate sales of comparable gas made in the market area during the relevant time, is there any logical reason to exclude them from consideration? The effect of excluding or including these sales in determining the market value of gas may or may not be significant. But if the concept of a blanket exclusion of all affiliate sales is carried further, the result could be extremely damaging to a lessee. For example, if gas is clearly being sold "at the well" by the lessee but only to an affiliate, the exclusion of such a sale from consideration, under a royalty clause similar to that involved in *Middleton*, could result in a finding that no sale of such gas is made "at the well." The significance of such a finding could be the difference between calculating royalty due on the basis of the proceeds received from the sale of the gas or making such calculation on the basis of the *Vela* market value standard.

118. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 362 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981). For a discussion of the court's statement concerning the relevant market area, see notes 98-99 *supra* and accompanying text.

119. *See id.* at 362. In this regard the court may have been referring, in part, to: (1) the failure to take into consideration the price circumstances surrounding the contracts for the sale of gas which were included in the market value determination; and (2) the failure to distinguish between gas which was free to be sold each quarter, and that which was committed for sale under long-term contracts or pursuant to an interstate dedication.

120. *See id.* at 362. This criticism seems to refer to the failure to take into account all sales of gas, or at least all sales of new gas, made in the market area, rather than just averaging the three *highest priced* sales of *new* gas.

121. *See id.* at 362. This seems to be an invalid criticism by the *Middleton* court because *Vela*, as the court itself recognized, stated "the mathematical average of all prices paid in the field is *not* a final answer to the difficult problem of determining market price." Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 873 (Tex. 1968) (emphasis added).

122. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 362 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981).

123. *See id.* at 362.

mitted for sale under a long-term contract by reference to "the volume-weighted average of all committed gas delivered in the market area."[124] The court did, however, express some affinity for the method offered by the royalty owners' expert, which consisted of averaging the three highest priced sales of gas (comparable in terms of quality, quantity, and availability) occurring in a two-county area each quarter.[125]

Thus, prior to the Texas Supreme Court's *Middleton* opinion, there had been no consistency among the appellate courts applying Texas law concerning the proper way to calculate the market value of gas committed for sale in the intrastate market under long-term contracts. Only one post-*Vela* court had expressly approved any method offered by an expert witness,[126] and that method had been expressly rejected by a sister court.[127] Obviously, confusion prevailed with regard to this issue.

The post-*Vela* cases addressing the proper determination of the market value interstate gas, although less inconsistent, were also less helpful than those dealing with intrastate gas. *Kingery* and *Weatherford* did not address the issue. The former simply held that regulated and unregulated sales of gas were not comparable sales within the meaning of the *Vela* test;[128] the latter held only

124. Butler v. Exxon Corp., 559 S.W.2d 410, 417 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). One might speculate that the *Butler* court's rejection of this method was based upon logic similar to that employed by the *Middleton* court in its analysis of the weighted average price which constituted Exxon's "field price." That reasoning and criticism was directed at the inclusion of *all* sales from the field, interstate as well as intrastate, in calculating the weighted average price and did not constitute a rejection *per se* of all weighted average computational methods. See notes 67-69 *supra* and accompanying text.

125. *See* Butler v. Exxon Corp., 559 S.W.2d 410, 417 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). The trial court, on remand, did not follow the suggestion of this *Butler* court. The case thereafter was appealed again, this time to the San Antonio Court of Civil Appeals where the trial court's market value decision was upheld. Most of the issues in the case were resolved under the theory that the "law of the case," as announced by the El Paso court in the previous *Butler* decision, controlled. *See* Exxon Corp. v. Butler, 585 S.W.2d 881, 884 (Tex. Civ. App.—San Antonio, 1979), *writ dism'd per curiam,* 24 Tex. Sup. Ct. J. 391 (May 16, 1981). After a writ of error was granted the parties settled. The supreme court, therefore, in a *per curiam* opinion, dismissed the cause as moot and set aside the judgments of the courts below. *See* Exxon Corp. v. Butler, 24 Tex. Sup. Ct. J. 391, 392 (May 16, 1981).

126. *See* Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.).

127. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 357-58 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd,* 613 S.W.2d 240 (Tex. 1981).

128. *See* notes 83-85 *supra* and accompanying text.

that the royalty owners had failed to prove their claim to additional royalty on the basis of the market value of the gas because their proof of market value had mixed sales of interstate and intrastate gas, which by definition were non-comparable sales.[129] *Hemus* was only slightly more helpful, holding that a weighted average price derived by averaging sales of interstate and intrastate gas was not an acceptable method for calculating market value of gas.[130]

The most enlightening opinion on this point dealing with interstate gas was that rendered by the United States District Court for the Northern District of Texas in *Brent v. Natural Gas Pipeline Co. of America*,[131] one of the two consolidated cases affirmed and superseded by the Fifth Circuit's decision in *Kingery*.[132] *Brent*'s primary holding was that there are two markets for gas in every geographical area, intrastate and interstate, and that only sales of interstate gas were comparable to determine the market value of gas committed for sale in the interstate market.[133] *Brent* went further, however, and adopted the position that the market value of the interstate gas in question was the FPC area rate prevailing for the geographical area in which the wells producing such gas were located, reasoning that this price was the only price being charged

129. *See* notes 88-89 *supra* and accompanying text. The dissenting opinion in *Weatherford*, however, describes the evidence of market value offered by the parties in the case. *See* First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783, 788-89 (Tex. Civ. App.—El Paso 1980, writ granted) (Osborn, J., dissenting). The royalty owners' expert concluded that the market value of the subject gas was the average of the three highest prices paid for gas in Texas Railroad Commission Districts 7c and 8. The lessee's expert based the market value of this gas on a weighted average price of four comparable sales, arriving at a market value ranging from 14.4¢ per Mcf in March 1974 to 22.6¢ per Mcf in April 1979. *Id.* at 788-89.

130. *See* Hemus & Co. v. Hawkins, 452 F. Supp. 861, 866 (5th Cir. 1978). The *Hemus* decision, however, does not constitute an absolute rejection of the weighted average price method, since the holding on this point naturally follows from the court's position that interstate and intrastate gas sales are not comparable to each other. As noted in the text, in *Hemus*, sales of both types of gas had been included in calculating the weighted average price offered as market value; hence the disapproval of that method.

131. 457 F. Supp. 155 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980). The companion case, consolidated with *Brent* for purposes of appeal was *Hawley v. Natural Gas Pipeline Co. of America*, 457 F. Supp. 155 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980).

132. *See* Kingery v. Continental Oil Co., 626 F.2d 1261, 1265-66 (5th Cir. 1980). See also notes 83-85 *supra* and accompanying text.

133. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980).

for interstate gas in that area.[134]

D. *The Effect of Division Orders.*

In an effort to avoid the impact of the *Vela* decision, some of the lessees in post-*Vela* market value gas royalty cases contended that the royalty provisions of their respective oil, gas, and mineral leases had been amended by subsequent agreements such as division orders[135] or pooling agreements.[136] In some instances, the lessees also constructed an estoppel argument based on such agreements. As with the other issues discussed previously, the decisions in the post-*Vela* cases with respect to these contentions were not uniform.

In *Middleton,* Sun Oil Company (Delaware) (Sun), one of the lessees, contended that its lease, which initially had provided for royalties based upon the market value of the gas at the wells, had

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134. *Id.* at 160. This holding, had it not been appealed, would necessarily be limited to its facts, insofar as it does not anticipate a situation in which interstate gas could be sold at prices less than the applicable federal ceiling price. In such a case, the resulting market price would be less than the regulated ceiling price. In this respect it is noteworthy that the Fifth Circuit in *Kingery* did not offer an opinion concerning what is, or is not, the market value of regulated gas. *See* Kingery v. Continental Oil Co., 626 F.2d 1261, 1264 (5th Cir. 1980).

135. A division order directs the purchaser of oil or gas to make payment for the value of the products taken to the persons, and in the proportions, set forth therein. The division order customarily is prepared by the purchaser of the production on the basis of the ownership shown in a title opinion covering the leased premises which is prepared at the instance of the lease operator. The purchaser will usually require that all those having an interest in the production from the given lease execute the division order prior to the commencement of payment thereunder. H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 159 (1978); *see* Bounds, *Division Orders,* SW. LEGAL FOUNDATION 5TH INST. ON OIL & GAS LAW & TAX. 91 (1954); Ethridge, *Oil and Gas Division Orders,* 19 MISS. L.J. 127 (1948).

136. A pooling agreement is one which brings together separately owned interests in small tracts of land for the purpose of obtaining a well permit under the applicable spacing rules of the governing regulatory authority. The theory of pooling is premised upon the prevention of drilling unnecessary and uneconomic wells which would result in physical and economic waste. H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 438-39 (1978); *see* Whelan v. Manziel, 314 S.W.2d 126 (Tex. Civ. App—Texarkana 1958, writ ref'd n.r.e.). *See generally* L. HOFFMAN, VOLUNTARY POOLING AND UNITIZATION (1954).

On the other hand, a unitization agreement provides for the joint operation of all, or some, of a producing reservoir for the purpose of promoting the most efficient recovery of the maximum amount of the reservoir's recoverable hydrocarbons. A unitization agreement is essential for the proper utilization of pressure maintenance or secondary recovery operations with respect to common producing pools. H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 625-26 (1978). *See generally* L. HOFFMAN, VOLUNTARY POOLING AND UNITIZATION (1954).

been amended by division orders, the terms of which established the proceeds received from sales of the gas produced under the lease as the basis for royalty payments.[137] The royalty owners contended that these division orders were not binding because they were not supported by consideration and had been revoked unilaterally. The court of civil appeals in *Middleton* agreed with Sun, holding that division orders were contracts which, in that case, were supported by consideration and, therefore, amended the lease royalty provisions in the manner contended by the lessee.[138] The court also held that because the division orders were supported by consideration, they could not be unilaterally revoked by the lessors.[139]

The effect of a division order upon a royalty obligation set forth in an oil, gas, and mineral lease was also discussed in *Butler*. *Butler* reached the opposite result from *Middleton,* holding that division orders generally, and the one involved there particularly, were executed without any consideration and, therefore, were not enforceable.[140] By implication, the *Butler* court held that the division order did not amend the lease and expressly rejected any estoppel-based contention, reasoning that the lessee had not relied upon the division order to its detriment.[141] None of the other post-*Vela* cases directly faced this issue.[142]

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137. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 364 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981). The division order argument was raised by Sun and Exxon, both lessee-defendants in the case. Exxon's division orders, however, were found to provide for the payment of royalty on the basis of the market value at the well of the gas sold or used off the leased premises and were, therefore, held not to vary the terms of the royalty clause contained in its lease. Sun's division orders had different provisions, including the "life-of-the-lease" term mentioned in the text. It is Sun's division orders which are important here and only they are discussed. The "life-of-the-lease" term of Sun's division orders is unusual, division orders generally being made terminable at the will of either party. *See* H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 159 (1978).

138. Exxon Corp. v. Middleton, 571 S.W.2d 349, 365 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981). The court found the necessary consideration in the form of additional duties imposed upon Sun by the division orders which Sun had not previously been bound to do, including keeping certain charts and records of various data and making them available for inspection at reasonable times. *Id.* at 365.

139. *Id.* at 365.

140. Butler v. Exxon Corp., 559 S.W.2d 410, 416-17 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

141. *Id.* at 416-17.

142. Although the effect of a division order as an amendment of a market value gas

Thus, as with almost every other issue raised in post-*Vela* market value gas royalty claims, the matter of the effect of an executed division order upon a lessee's market value royalty obligation under an oil, gas, and mineral lease generated conflicting opinions among courts applying Texas law to these claims. The stage was set for, and the circumstances demanded, a clear, precise, definitive treatment of these post-*Vela* issues by the Texas Supreme Court. As its vehicle to address these matters, the court selected *Exxon Corp. v. Middleton.*[143]

IV. *Exxon Corporation v. Middleton:* CLEANING UP THE RUBBLE?

Although the factual circumstances involved in *Middleton* previously were described in cursory fashion, it is appropriate to review them in more detail here. Exxon was the successor to the interest of the lessee under four mineral leases (Exxon leases) executed between 1933 and 1935.[144] Similarly, Sun was the successor to the interest of the lessee in six other mineral leases (Sun leases) executed between 1933 and 1941.[145] All of the gas involved was produced from the Anahuac Field located in Chambers County,

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royalty provision is also discussed in *Brent v. Natural Gas Pipeline Co. of America,* the court there concluded the division order's terms had not been observed by the parties and, therefore, had been abandoned. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 159 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980). In *Hemus & Co. v. Hawkins,* the court rejected the contention that the royalty owners had ratified the royalty payment method employed by ratifying the agreement which pooled their lease with other leases. The court reasoned that the lease had been force pooled and also that the lessee previously had paid royalty upon the assumption there had been no such ratification. Hemus & Co. v. Hawkins, 452 F. Supp. 861, 866 (S.D. Tex. 1978). Further, in *Kingery v. Continental Oil Co.,* the court held there had been no ratification of the royalty payments made pursuant to division orders because the division orders involved had expired prior to the period for which the royalty owners sought recovery. Kingery v. Continental Oil Co., 434 F. Supp. 349, 356 (W.D. Tex. 1977), *rev'd,* 626 F.2d 1261 (5th Cir. 1980). *See also* Amoco Prod. Co. v. First Baptist Church, 579 S.W.2d 280, 288, 290 (Tex. Civ. App.—El Paso 1979) (lessee seeking to enforce division order provision for payment of net proceeds as royalty as against royalty owner's claim of breach of an implied covenant to use good faith in marketing gas production from the lease), *writ ref'd n.r.e. per curiam,* 611 S.W.2d 610 (Tex. 1981); First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783, 792-93 (Tex. Civ. App.—El Paso 1980, writ granted) (Osborn, J., dissenting) (discussing division orders).

143. 613 S.W.2d 240 (Tex. 1981).

144. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 242 (Tex. 1981).

145. *See id.* at 242.

Texas.[146] The gas produced by Exxon under its leases, was processed at its Anahuac Gas Plant which, although not situated on any of the Exxon leases, was located in the Anahuac Field.[147] After processing, this gas was delivered either to the City of Anahuac, Houston Pipeline Company, or the Exxon Gas System at the tailgate of the plant.[148] The gas delivered into the Exxon Gas System, an intrastate marketing system owned by Exxon, ultimately was sold and delivered to several industrial customers[149] at their respective plant gates. All of the gas produced under the Sun leases was processed off the leased premises at Union Texas Petroleum Company's Winnie Plant.[150] During the period involved in the suit, Sun's gas was sold and delivered to Pan American Gas Company[151] at the tailgate of the Winnie Plant.

All of the gas involved in *Middleton* was sold in the Texas intrastate market pursuant to long-term gas sale agreements.[152] The royalties paid by the lessees on this gas were calculated on bases other than the market value of the gas. Exxon calculated the royalties with regard to the gas it sold to the City of Anahuac on the basis of the proceeds actually received from the sale of that gas, which sales were made at Exxon's field price.[153] The royalties paid by Exxon on gas delivered into the Exxon Gas System were also

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146. *Id.* at 242.

147. *Id.* at 242.

148. *Id.* at 242. Gas which remains after processing in a separator or gas processing plant where the liquid hydrocarbons are removed therefrom is often referred to a "residue gas." H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 500 (1978). *See* Read v. Britain, 414 S.W.2d 483 (Tex. Civ. App.—Amarillo), *aff'd*, 422 S.W.2d 902 (Tex. 1967).

149. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 242 (Tex. 1981). These industrial users included Gulf States Utilities Company, E. I. DuPont De Nemours & Company, and Neches Butane Products Company.

150. *Id.* at 249.

151. *Id.* at 249. Pan American Gas Company was a predecessor of Amoco Gas Company. The price paid by Pan American to Sun for this gas was 17.58¢ per Mcf. Sun calculated and paid royalties on this gas on the basis of this contract price. *Id.* at 249.

152. The parties stipulated that during the relevant years (1973-1975) all of the gas from these leases was sold in intrastate markets in Texas. *Id.* at 246. Sun's gas was sold under a gas contract dated July 5, 1951, as amended July 22, 1965. *Id.* at 249. The *Middleton* opinion does not state the length of the term of those contracts under which Exxon sold its gas, but the mere filing of a market value royalty claim indicates that, at least in the opinion of the royalty owners, the sales were made under a contract sufficiently old as to not reflect current market prices.

153. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 356 (Tex. Civ. App.—Houston [14th Dist] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981). The method by which Exxon calculated its "field price" is discussed at note 67 *supra* and accompanying text.

based upon its field price.[154] The royalties on the remaining Exxon gas involved in *Middleton* were calculated and paid on the basis of the proceeds received by Exxon from the sale of the gas.[155] All of the royalties paid with regard to Sun's gas were calculated on the basis of the proceeds received by Sun from the sale of such gas.[156]

All of the *Middleton* gas, Sun's and Exxon's, was covered by the provisions of various division orders which purported to direct the payment of royalty to the persons and in the proportions specified therein and provided for the payment of royalty on the basis of the amount realized from the sale of the subject gas.[157] The gas was also subject to the terms of a unit agreement applicable to the Anahuac Main Frio Gas Unit No. 1.[158]

The gas royalty clauses in the leases involved were remarkably similar. The Exxon gas royalty clause provided that royalties:

> on gas, including casinghead gas or other gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other product therefrom, shall be the market value at the well of one-eighth of the gas so sold or used, provided that on gas so sold at the wells the royalties shall be one-eighth of the amount realized from such sale.[159]

The Sun gas royalty clause provided in nearly identical terms that Sun would pay royalty:

> on gas, including casinghead gas or other gaseous substances, produced from said land or sold or used off the premises, or used in the manufacture of gasoline or other products therefrom, by lessee, the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells, the royalty shall be one-eighth of the amount realized from such sale.[160]

The *Middleton* royalty owners claimed that Exxon and Sun had breached the royalty payment provisions of their respective leases by failing to pay royalties on gas produced thereunder on the basis

154. *Id.* at 356.
155. *Id.* at 356. This gas was that which Exxon sold to the Houston Pipeline Company.
156. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 249 (Tex. 1981).
157. *Id.* at 249-51. This aspect of the case is analyzed in detail at notes 208-36 *infra* and accompanying text.
158. *See id.* at 251.
159. *Id.* at 242.
160. *Id.* at 242.

of its "market value at the well." The lessees contended that all the sales of gas involved occurred "at the wells," within the meaning of the various gas royalty clauses, and therefore, royalties were payable on the basis of the amount realized from the sale of the gas involved and not on the basis of the market value of the gas.[161] Alternatively, on the assumption that the market value gas royalty standard applied, the lessees attacked the method by which the royalty owners sought to establish the market value of such gas,[162] and also claimed that the market value royalty standard had been replaced by the terms of the unit agreement or the division orders which covered the subject production.[163]

The supreme court held with regard to the construction of the royalty clauses that gas "sold or used off the premises" refers to any gas sold at locations beyond the boundaries of the leased premises, while gas "sold at the wells" includes only gas sold at the wells located within the lease boundaries.[164] This construction of the royalty clauses caused the court to conclude that the sales of the subject gas made at the tailgates of processing plants located off the leased premises, had occurred "off the premises," and that, therefore, the royalty due with respect to such gas was determinable by reference to the market value of that gas.[165]

With respect to the effect of Sun's and Exxon's division orders upon their respective royalty obligations, the supreme court stated that division orders are binding upon the signatories thereto only for so long as the parties mutually act in accordance with their terms.[166] On that basis the supreme court held, by implication, that royalty payments made and accepted under the division orders presented discharged the lessees' royalty obligation for the period of time covered by those payments.[167] As a matter of law, however, the court held that the division orders involved had been revoked upon the filing of the *Middleton* suit[168] and thereafter did not bind the parties. Conversely, the court held that the terms of

161. *Id.* at 243.
162. *Id.* at 244-49.
163. *Id.* at 249-52.
164. *Id.* at 244.
165. *Id.* at 244.
166. *Id.* at 250.
167. *Id.* at 252.
168. *Id.* at 251.

the unit agreement did not alter the royalty payment obligations fixed under the subject oil, gas, and mineral leases covering the various tracts unitized thereunder.[169]

The emphasis of the *Middleton* opinion rests, however, with the court's discussion of the proper method of determining the market value of gas committed to be sold under a long-term contract. The court adopted a two-step approach to this aspect of the case. Noting that all parties agreed that the market value of gas is determinable at the time the gas is sold, the court first addressed the matter of *when* gas is sold and then, having resolved that issue, the court considered *how* the market value of gas committed to long-term contracts should be determined.[170] Regarding when gas is "sold" for royalty purposes, the court affirmed its holding in *Vela* that gas sold pursuant to long-term contracts is sold at the time of each delivery of such gas, rejecting various arguments by the lessees which sought to discredit that aspect of the *Vela* decision.[171] Turning to the matter of *how* the market value of gas committed for sale under a long-term contract should be calculated, the court announced the following principles of broad applicability:

1. The market value of such gas should be determined as though the gas is free and available for sale.
2. Market value may be calculated by using sales of gas comparable in time, quality, quantity, and availability to marketing outlets.
3. Sales comparable in time are those made under contracts executed contemporaneously with the sale of the subject gas.
4. Sales comparable in quality are those of gas having similar physical properties and legal characteristics.
5. Sales comparable in quantity are those of gas sold in similar volumes.
6. Sales of gas comparable with respect to availability of marketing outlets are those which could have been sold to the same type of market (e.g. intrastate or interstate).
7. Comparable sales should be drawn from the relevant market area, which area may be, but is not required to be, the field from

169. *Id.* at 251-52. The court's resolution of this aspect of *Middleton* seems questionable and is discussed in detail herein in text accompanying notes 192-207 *infra*.

170. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex. 1981).

171. *Id.* at 244-46. Exxon's principal contention was that gas is "sold," for purposes of making market value royalty calculations, when it is committed for sale and that occurs at the time the long-term contract pursuant to which the sales are made is executed. *See id.* at 244-45.

which the subject gas is produced.[172]

Applying these standards to the facts presented, the *Middleton* court had little difficulty finding the existence of evidence to support the trial court's judgment adopting the market value determination of the royalty owners' expert witness.[173] The court affirmed the trial court's finding that the relevant market area in this case was the geographic area covered by Texas Railroad Commission Districts 2, 3, and 4 on the basis of expert testimony that "comparable sales" occurred in this area and that gas production, consumption, and transportation facilities existed in that market area as well.[174] Additionally, the court found that the sales of gas used by the royalty owners' expert in calculating his version of the market value of the subject gas satisfied the court's conception of "comparable sales." The sales utilized by the expert were sales of "sweet" gas[175] sold in the Texas intrastate market, the same type of gas and the same form of sale involved in the action, and the prices charged in these sales had been adjusted by the expert to account for variances in the Btu content of the respective volumes of gas, thereby furthering the comparability of the sales.[176] Further, although the expert used sales of varying volumes, the court found that the volume of gas sold in these circumstances did not affect the comparability of the prices charged for the gas.[177] The court also held the sales were comparable in their availability to

172. *Id.* at 246-47.

173. *Id.* at 249. This aspect of the case was presented to the court on various "no evidence" points of error, thus the affirmance of this part of the trial court's judgment based upon the existence of "some evidence." *See id.* at 249.

174. *See id.* at 247. The court also found support for its approval of this area as the relevant market area in the fact that this area is often used as the relevant market area in price redetermination clauses of gas sale contracts covering gas produced along the Gulf Coast, the general geographical area from which the *Middleton* gas was produced. *See id.* at 248.

175. "Sweet" gas commonly refers to gas of high purity, that is, gas which is not contaminated with impurities such as sulphur compounds. Except for the removal of any liquid hydrocarbons that may be present in the gas, sweet gas is ready for commercial and domestic use. H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 585 (1978).

176. The Btu content of a volume of gas refers to its heating value. The higher the Btu content of gas, the more value it has because it possesses more heating capability. Conversely, the less Btu content possessed by a volume of gas, the less heating capability it possesses and, correspondingly, the smaller its dollar value. Thus, for purposes of comparing the market value of various volumes of gas, it is appropriate to compare their Btu values and make some kind of value adjustment to reflect any variances therein.

177. Exxon Corp. v. Middleton, 613 S.W.2d 240, 247 (Tex. 1981).

marketing outlets because the gas fields in the selected marketing area were interconnected through a network of interstate and intrastate pipelines.[178] Moreover, the sales were held to be comparable in time, the parties having stipulated that the market value determination should be made quarterly, and the evidence offered by the royalty owners' expert having conformed to that time standard.[179] Finally, the court affirmed the computational method used by the royalty owners' expert in determining market value of the *Middleton* gas. This method constituted an average of the three highest prices, adjusted for Btu content variances, charged for gas sold in the market area during the first month of each quarter of the period involved in the suit.[180]

A. *"Off the Premises" or "At the Wells"?*

The *Middleton* decision is, of course, significant in several respects, but the court's construction of the royalty clause involved in the case is particularly important because, while royalty clauses may vary to some extent in their express provisions, the basic royalty provision involved in *Middleton* is the most common form of royalty clause used in oil, gas, and mineral leases.[181]

The court's initial task in construing the terms of the *Middleton* gas royalty clause was to ascertain the intention of the parties in using the words "sold or used off the premises" and "sold at the wells." In attempting to perform this function, however, the court limited its examination to the bare terms of the clause itself, basing its construction upon a grammatical analysis of the clause. Focusing upon whether the phrase "off the premises" modified the

178. *Id.* at 247-48.

179. *Id.* at 248.

180. *Id.* at 248. The three highest prices were used by the royalty owners' expert, and approved by the court, on the theory that gas prices were constantly increasing during the relevant period of time. The highest prices, the court theorized, represented the most current sales of that period and, therefore, most closely approximated the current market value of the subject gas. In passing, it should be noted that the court rejected Exxon's contention that its "field price," which is based upon a mixture of interstate and intrastate gas prices, conclusively established the market value of this gas. The court held, as a matter of law, that the mixture of interstate and intrastate sales used to determine the "field price" was not comparable in quality to the sales of the subject intrastate gas because of the differing legal and conceptual characteristics possessed by each category of gas. *See id.* at 248.

181. Hoffman, *Oil And Gas Royalty Problems—Current Issues And Answers*, SW. LEGAL FOUNDATION 31ST INST. ON OIL & GAS LAW & TAX. 211, 214 (1980).

word "sold" as well as the word "used," and whether the phrase "at the wells" included sales which occurred beyond the boundaries of the leased premises, the court concluded that the term "sold or used off the premises" referred only to sales consummated by deliveries made at locations beyond the boundaries of the leased premises, while the term "sold at the wells" referred exclusively to sales made on the leased premises.[182]

Given the inartful wording of the royalty clause involved, the court's analyses and conclusions concerning these matters are not unreasonable. The interpretation accorded the language of this gas royalty clause by the court reflects an effort to assign a harmonious meaning to the entire clause and is premised upon a reasonable construction of the express words used therein. However, in riveting its attention solely upon the sentence structure employed in the *Middleton* royalty clause, the court effectively chose to construe the language of the clause in a vacuum, devoting almost no attention to the circumstances surrounding the execution of the lease, or industry parlance with respect to these particular lease terms, or any other indicia of the parties' intent. In fact, in reaching its conclusion concerning the proper construction of the gas royalty clause, the *Middleton* court seems to have ignored obvious indications that the parties' intent with respect to this clause was contrary to that found by the court. For example, it seems curious that in a clause in which the parties, according to the court, used the language "off the premises" to describe an activity occurring off the lease, they would have used, in the very next phrase of that same clause, any language other than "on the premises" to describe the same activity occurring on the lease. In this light, it seems doubtful that the parties intended the phrase "at the wells" to mean "on the premises." Had the parties intended what the court held, that is, that the lease's gas royalty clause had two distinct royalty provisions, one applicable to gas sold "off the premises" and the other to gas sold "on the premises," they easily could have used those mutually exclusive terms. Since the parties did not do that, a construction according that very effect to the royalty

182. Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex. 1981). In so holding the court expressly disapproved the contrary construction given this royalty clause in *Butler v. Exxon Corp.*, 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.). *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex. 1981).

terms which the parties did use seems inappropriate.

The court's construction of the *Middleton* royalty clause also seems inappropriate because it does not give full meaning to each word contained in the clause. The construction given the clause by the court is one which accords the "market value" portion of the clause and the "amount realized" portion of the clause mutually exclusive applicability. This interpretation, however, ignores the meaning of the word "provided" which, as used in the royalty clause, renders the "proceeds" part of the clause a "provisio," that is, a clause which limits or restricts the applicability of that which precedes it.[183] With reference to the gas royalty clause, the court held that the language preceding the proviso specified that the royalty on gas sold "off the premises" shall be based on market value; yet the court construed the language of the proviso to apply to gas *not* covered by the preceding "market value" clause, holding that the proviso applied only to gas sold "on the premises." The court's construction does not assign a limiting or restrictive function to the proviso at all, ignoring the significance of that word in the *Middleton* gas royalty clause. The court interpreted the clause as though the term "provided" was not present within the clause and thereby overlooked a significant indication that the parties intended something other than the mutually exclusive construction given by the court to the scope of the clause's two royalty standards.

Not only does the court's interpretation of the *Middleton* gas royalty clause apparently fail to reflect the true intention of the parties, it also seems capable of producing inequitable and unintended results among the gas producers and royalty owners of this state. For example, the court's holding invites discriminatory treatment of gas royalty owners having interests in the same productive area. In many instances gas is produced from contiguous leases, gathered from the leases, and delivered to the purchaser at a central point in the field located on one of the continguous leases.[184] Under the court's interpretation of the *Middleton* gas royalty

183. *See* South Tex. Mortgage Co. v. Coe, 166 S.W. 419, 422 (Tex. Civ. App.—Austin 1914, no writ).

184. Such a central delivery point most often occurs when the gas involved is processed at a centrally located separator or processing plant, with delivery of the residue gas made to the purchaser at the tailgate of the processing facility.

clause, the royalty owner under a lease covering the land on which the delivery is made would receive royalty on his gas measured on the basis of the proceeds received from its sale, while the royalty owners under another lease in the same field whose gas is delivered to its purchaser at some point beyond their lease's boundaries would be paid royalty on the basis of the market value of the gas. Today, when the market value of gas is subject to fluctuation, the discriminatory effect upon the royalty owners in such circumstances is obvious. It seems unfair that the court's holding potentially would produce varying royalty consequences of such a substantial economic nature as to gas of the same quality produced under leases covering land located in the same field. Differing royalty treatment resulting from the fortuitous location of the delivery point of the gas in question is an unreasonable and unsatisfactory consequence of the *Middleton* decision.[185]

The potential unfairness of the court's construction of the *Middleton* gas royalty clause is further demonstrated by its application to leaseholds of varying size. In Texas, oil, gas, and mineral leaseholds vary greatly in size.[186] Applying the *Middleton* gas royalty formula, deliveries of gas occurring anywhere on the leased premises, whether that lease be 1/10th of an acre or 85,000 acres, would result in royalty on that gas being calculated on the basis of the proceeds received from its sale, and not by reference to its market

185. An excellent illustration of the absurd results which could be generated by the court's construction of this clause appeared in one of Exxon's briefs filed with the court. Exxon hypothesized a situation that involved the delivery of a volume of gas one foot *inside* the boundary of the lease from which it was produced and the delivery of another volume of gas produced from a neighboring lease in the same field and reservoir one foot *beyond* the boundary of the neighbor's lease. Under the court's interpretation of this gas royalty clause, the difference of *one foot* in the delivery point would make the royalty on the first volume of gas determinable by reference to the proceeds of its sale and the royalty on the second volume of gas determinable by reference to its market value. The actual dollar differential between such royalty calculations created by a variance of one foot in the delivery point of the gas could be staggering.

186. Some leases are as small as 1/10th of an acre. *See* Benz-Stoddard v. Aluminum Company of America, 368 S.W.2d 94, 96 (Tex. 1963). Other leases can be as large as 85,000 acres. *See* W. T. Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 509, 19 S.W.2d 27, 27 (1929). Additionally, in some instances the wellhead is not even located on the lease itself, as where the lease is being produced through directional wells. In such a case, and assuming the applicability of a royalty clause similar to that involved in *Middleton*, the court's interpretation could produce the bizzare result of having a sale of gas with delivery precisely at the wellhead being considered a sale "off the premises" and subject to the market value royalty standard.

value. This could generate the potentially inequitable circumstance of having the royalty on gas produced from a small leasehold in a field which is delivered just beyond the lease lines being calculated on the basis of the market value of the gas, while royalty on similar gas produced from a very large leasehold in the same field and delivered to the purchaser miles from the wellhead, yet still within the lease boundaries, is calculated on the basis of the proceeds received from the sale. The parties to the *Middleton* lease, and parties to leases with similar gas royalty clauses as well, could not have intended such potentially unfair results with regard to royalty payment rights and duties. Certainly it was not intended that such differing royalty results could arise with respect to the same quality of gas, produced from the same field or reservior, and sold to the same purchaser, solely as a result of the placement of the delivery point of the gas.[187]

Finally, an unavoidable consequence of this aspect of the *Middleton* decision may be that the delivery point of any gas produced under leases having gas royalty clauses similar to that construed in *Middleton* will become a matter of negotiation between lessor and lessee at the time the lease is entered into. This would be an undesirable development in the petroleum industry because the location of the delivery point of produced gas should be governed solely by physical operating factors and considerations of economical lease operation and should not be affected by gas royalty standards.

Perhaps the *Middleton* court could have been better served by engaging in a construction of these gas royalty clauses based upon a practical approach to the language of the clause and the probable intent of its drafter. One such reasonable construction of this gas royalty clause which the court could have adopted is suggested by the division of gas production into three categories for royalty payment purposes: (1) "gas used on the premises," (2) "gas sold or used off the premises," and (3) simply "sold" gas. These divisions appear in oil, gas, and mineral leases as a means of assigning dif-

187. In fact, the original parties to the *Middleton* leases could not possibly have intended that their gas royalty clauses would be construed in this manner, because when those leases were entered into, the area covered by them was undeveloped, and no one could have anticipated the location of the gas wells, pipelines, or delivery facilities vis-a-vis the lease boundaries.

fering royalty standards to gas on the basis of whether or not the gas is being used for the mutual benefit of the parties.[188] For example, oil, gas, and mineral leases generally provide for the free use of gas by the lessee when used "on the premises" because such gas is consumed in connection with furthering the continued production of hydrocarbons from the leased premises and is, therefore, considered to be used for the mutual benefit of the lessor and lessee.[189] By comparison, this analysis suggests that the "market value" gas royalty standard applicable to gas that is "sold or used off the premises" is intended to apply to gas that is used or sold solely for the benefit of the lessee.[190] Such gas, under this anlaysis, is that which is either used by the lessee off the leased premises in operations on other leases in the field or that which is sold by the lessee to others in the field under circumstances constituting something other than their arm's-length transactions.[191] In such circumstances, this analysis suggests that the "market value" royalty standard was necessarily included in the oil, gas, and mineral lease as a means of measuring the amount of royalty due with respect to such gas because there is no other reasonable standard available. Certainly, insofar as such gas is "used" off the premises there is no "amount realized" upon which to premise a royalty calculation and, there being no such standard available, the "market value" concept is a logical alternative for determining the worth of the "used" gas. Likewise, the sales of gas made to others off the premises at something less than full value, or in circumstances indicating something other than an arm's-length transaction, require some basis other than actual receipts for making royalty payment calculations and the market value concept again lends itself to performing this function. Such sales, for example, could include sales to affiliates at unreasonably low prices or to other lessees in the field in exchange for non-monetary consideration. In each instance, the reliance upon the market value standard results from the need to protect the royalty owner from the consequences that follow the use of a "proceeds" basis for royalty payments in situations which

188. The basis for this interpretation is suggested by the dissenting opinion of Chief Judge Preslar in the *Butler* case. *See* Butler v. Exxon Corp., 559 S.W.2d 410, 417-18 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.)(Preslar, C. J., dissenting).

189. *See id.* at 418.

190. *See id.* at 418.

191. *See id.* at 418.

do not reasonably lend themselves to that type of measure.

Conversely, under this analysis the "proceeds" or "amount realized" gas royalty standard should be applicable to all other sales of produced gas including all arm's-length sales of such gas. This logically would follow from the notion that arm's-length sales would, by definition, be the result of effective bargaining between the seller and purchaser of the gas, thus eliminating the need to protect the royalty owner from the unfavorable consequences of a royalty valuation based upon a use or sale of the gas beneficial only to the lessee. With the need to protect the royalty owner no longer present, the corresponding need to calculate his royalty on the artificial basis of its market value also disappears. The proceeds derived from a sale of the gas which is beneficial to both the lessor and lessee thus becomes the logical and least complex method of calculating royalty due on such gas. Certainly this seems to be a reasonable construction of the *Middleton* gas royalty clause and one which may better reflect the true intent of the parties to that lease and to other similar leases as well.

The words "at the wells" seem to impose a troublesome limiting effect upon this theoretical construction of this portion of the gas royalty clause, suggesting that the "amount realized" standard should apply only to arm's-length sales occurring "at the wells" and not to other arm's-length sales of gas. This would generate the problem of how to value sales of the latter type for royalty purposes, and whether the proposed construction could be accepted in light of the apparent failure to provide a standard for calculating royalty on the substantial volume of gas falling within this latter category of "sold" gas. It is not unreasonable to surmise, however, that the drafter of the form of gas royalty clause involved in *Middleton* considered that arm's-length sales of produced gas would naturally occur at the wellhead. This explanation gains credence from the fact that sales of gas away from the wellhead often occur at central facilities connected with the processing of the gas for the purpose of extracting natural gas liquids therefrom, a process which was not common at the time the *Middleton* lease was executed.

For these reasons, the hypothetical construction of the *Middleton* gas royalty clause suggested herein is a reasonable alternative to the grammatical construction proffered by the court, and one which better reflects the intent of the parties who agreed to be bound by its provisions.

B. *The Effect of Unitization Agreements and Division Orders Upon the Construction of the Gas Royalty Clause.*

After construing the terms of the *Middleton* gas royalty clause in the manner discussed above, the court turned its attention to whether the terms of the division orders and the unitization agreement altered the gas royalty payment obligations set forth in the gas royalty clauses. The court found that the division orders amended the lessees' royalty payment obligations only for the period in which the royalty owners accepted royalties tendered thereunder without objection, and held that the terms of the unitization agreement did not modify these obligations at all.[192] Both conclusions are at least questionable, if not erroneous.

1. *Unitization Agreements.* Portions of the *Middleton* leases were unitized, as to gas produced from one specific producing horizon, into the Anahuac Main Frio Gas Unit No. 1.[193] The unitization of this gas reservoir entitled all gas royalty owners under leases included in the unit to receive royalty on gas produced from the reservoir, whether or not such production was obtained through wells located on their respective leaseholds.[194] The *Middleton* lessees contended that the provisions of the unitization agreement effectively amended the gas royalty clause contained in the *Middleton* leases so that the provisions of the clause applicable to sales of gas "at the wells" should be construed to apply to sales of gas "on the unit."[195] Under this construction, since all of the *Middleton* sales occurred within the unitized area, all of them would have constituted sales "at the wells," and the royalty payable thereon would have been calculable on the basis of the proceeds received from those sales rather than the market value of the gas. The court rejected this contention, holding that the express terms of the unitization agreement provided that gas royalty payments remained calculable by reference only to the royalty clauses contained in the respective leases involved, without regard to the

192. Exxon Corp. v. Middleton, 613 S.W.2d 240, 249-52 (Tex. 1981).
193. *See id.* at 251; Exxon Corporation's Motion for Rehearing at 21.
194. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 251 (Tex. 1981).
195. *See id.* at 251.

terms of the unitization agreement.[196] This aspect of the *Middleton* decision appears contrary to established Texas law and, at best, is a questionable construction of the contract provisions involved.

It is quite common for the owners of mineral interests to enter into pooling or unitization agreements. Pooling agreements have the effect of bringing together several small tracts which might otherwise be ineligible for a drilling permit under local well spacing rules.[197] Unitization agreements, in contrast, provide for the joint operation of all or part of a producing reservoir or field as a single entity, without regard to surface boundary lines, for the purpose of maximizing the reservoir's productivity and enhancing the efficiency of its operation.[198] Thus, under the typical unitization agreement, wells may be drilled or located and operations conducted on the unitized premises without reference to interior property lines.[199] Generally, these agreements specify that drilling anywhere on the unit will keep the unitized lease in effect without payment of delay rental, and commercial production from any part of the unit will perpetuate all the unitized leases. Each member of the unit typically is entitled to share in all production from the unit. Each unitized lessor relinquishes the right to have his own tract separately developed and the right to receive all of the royalties on production from the wells on his own tract, but gains the

196. *See id.* at 251-52.

197. *See* 6 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 901 (1980). *See generally* L. HOFFMAN, THE LAW OF POOLING AND UTILIZATION (1954); C. MEYERS, THE LAW OF POOLING AND UNITIZATION—VOLUNTARY AND COMPULSORY (2d ed. 1980).

198. *See* H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 901 (1980). Unitization becomes particularly significant during secondary recovery operations where the freedom to flood parts of the reservoir and the location of injection wells, procedures designed to maintain reservoir pressure, are important to the continued successful recovery of hydrocarbons. *See id.*

199. *See id.* § 952. In Texas, it is held that unitization effects a cross-conveyance of interests in real property so that each participating royalty owner conceptually exchanges his interest in a tract or tracts for an undivided interest in the entire unit area. *See* Renwar Oil Corp. v. Lancaster, 154 Tex. 311, 315, 276 S.W.2d 774, 776 (1955); Veal v. Thomason, 138 Tex. 341, 349-50, 159 S.W.2d 472, 476 (1942). *See also* Phillips Petroleum Co. v. Ham, 228 F.2d 217, 220 (5th Cir. 1955); Whelan v. Placid Oil Co. 198 F.2d 39, 41-42 (5th Cir. 1952). Most current unitization agreements, however, expressly negate any intent to transfer legal title to leases or to effect any type of cross-conveyance; instead they simply create contractual rights for the sharing of unit production. In either case, the result is the same; the interior lease lines are obliterated and the unit area becomes, conceptually, one property.

right to share proportionately in royalties on production from wells located on other of the unitized tracts.[200] The net legal effect of unitization, therefore, is the recognition of a unitized tract as constituting a single, amalgamated leased property, with all of the lease contracts affecting land included in the unit constituting but one agreement, and all of the leases considered as one lease.[201]

Although the general effect of unitization is the creation of one amalgamated lease, unitization agreements commonly contain language requiring the lessee under each lease contributed to the unit to retain responsibility for the payment of royalty. The *Middleton* unit agreement contained such a clause providing, in pertinent part, that "settlement shall be made for royalties on . . . gas, or so much thereof as if [sic] sold or used off the premises, in accordance with the terms and provisions of each lease or other instrument creating Royalty Owners' interest."[202] The *Middleton* court construed this provision to mean that in determining each lessee's royalty obligation, the terms of the individual unitized leases alone controlled, effectively holding that in this respect the unitization agreement did not substitute unit lines for surface lease boundaries.[203] Thus, under *Middleton*, the construction given the gas royalty standards of "off the premises" and "at the wells" as referring to "off the lease" and "on the lease" was found not to have been amended by the unitization agreement. In fact, under this construction royalty calculations are made in a manner totally di-

200. *See* H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 951 (1980). *See also* Mengden v. Peninsula Prod. Co., 544 S.W.2d 643, 647-48 (Tex. 1976); Southland Royalty Co. v. Humble Oil & Ref. Co., 151 Tex. 324, 327, 249 S.W.2d 914, 916 (1952); Brown v. Smith, 141 Tex. 425, 431, 174 S.W.2d 43, 47 (Tex. 1943); Ruiz v. Martin, 559 S.W.2d 839, 843-44 (Tex. Civ. App.—San Antonio 1977, writ ref'd n.r.e.).

201. *See* 5 W. SUMMERS, THE LAW OF OIL AND GAS § 952 (1966); H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 901 (1980).

202. Exxon Corp. v. Middleton, 613 S.W.2d 240, 251-52 (Tex. 1981).

203. *Id.* at 251-52. In so holding, the court discussed and rejected an interpretation of the unit agreement and the gas royalty clauses proffered by various *amici curiae*. This interpretation was premised on the thought that the unit agreement's provisions operated to enlarge the geographical boundaries incorporated into the gas royalty provisions of the respective leases. The suggested construction would have made royalty with respect to gas sold anywhere within the unit area, instead of just within the leased premises, calculable on the basis of the amount realized from the sale and would have made royalty on gas sold beyond the unit boundaries, rather than beyond the leased premises, calculable on the basis of the market value of the gas. The court rejected this interpretation on the basis of its literal construction of the terms of the unit agreement. *See id.* at 251-52.

vorced from the provisions of the unitization agreement and solely in accordance with the terms of the respective lease agreement.

The construction given to this portion of the *Middleton* unitization agreement apparently was premised on the theory that the agreement's specific language relating to royalty calculation abrogated the generally applicable principle of Texas law that a unit constitutes one amalgamated leasehold. This holding may yield results that likely were not intended by the *Middleton* court. For example, under the *Middleton* court's construction of this form of unitization agreement and mineral lease, the royalty owners under the unitized lease on which the delivery point of gas sold from the unit exists would be paid royalty on the basis of the "amount realized" from the sale of the gas, even though the production may actually have been obtained from a different lease within the unit, while all other royalty owners in the unit would have their gas royalties calculated on the basis of the market value of the gas. In other words, a sale "on the premises" of a unitized lease which actually produces no unit gas, would cause the royalty owners thereunder to be paid royalty on the basis of the proceeds received from that sale, while royalty owners under the other leases in the unit, whether or not unit gas is produced therefrom, would be required to establish the market value of that gas in order to receive royalties in addition to that which they may have been paid.

This kind of variance in royalty payment rights and obligations bears no relation to the expectations of the parties to a unitization agreement who committed their property interests to the unit in the anticipation of sharing proportionately in the benefits and costs of production, an expectation derived from well established Texas law.[204] The *Middleton* decision will operate to frustrate that expectation. Now, instead of sharing proportionately in the cost of royalty incident to the production of gas, lessees in the position of the *Middleton* lessees will be required to observe varying, and in many circumstances, inequitable gas royalty payment standards dependent upon where the delivery of unit gas is made to its pur-

204. *See* H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 951 (1980). *See also* Mengden v. Peninsula Prod. Co., 544 S.W.2d 643, 647-48 (Tex. 1976); Southland Royalty Co. v. Humble Oil & Ref. Co., 151 Tex. 324, 327, 249 S.W.2d 914, 916 (1952); Brown v. Smith, 141 Tex. 425, 431, 174 S.W.2d 43, 47 (Tex. 1943); Ruiz v. Martin, 559 S.W.2d 839, 843-44 (Tex. Civ. App.—San Antonio 1977, writ ref'd n.r.e.).

chaser. This result certainly could not have been within the contemplation of the unit participants at the time they entered into the unitization agreement.

This portion of the *Middleton* decision also seems ill founded because from time to time over the life of the unit, the location of unit facilities and perhaps the delivery points of the gas being sold from the unit may change from a point on one unitized lease to another for purposes of economic efficiency or to increase recovery of hydrocarbons.[205] Changes of this kind now may also alter the gas royalty standard, as interpreted by the *Middleton* decision, under which gas royalty is calculated and paid, resulting in a corresponding alteration in the amount of royalty payments allocable to the affected unitized leases. The gas royalty standard, in these circumstances, would necessarily change from the "amount realized" standard to the "market value" standard whenever the location of the sale of the gas (defined by the court to mean its delivery) would change from "on the premises" to "off the premises." The amount of royalty payments conceivably could remain unchanged if the market value of the gas and its contract sale price were the same, but more likely than not, the amount of the payments would change to reflect any variance between the market value and the contract price of the gas. Such a result is illogical at best, and inequitable at worst.

The location of delivery points of gas production within a unitized area should not affect the standard by which the amount of the benefits to be derived from unit operations by individual royalty owners are calculable. If the location of these facilities or delivery points is determinative of the applicability of the "amount realized" or the "market value" gas royalty standards, unit lessees may begin to consider the implications for the payment of gas royalties of locating unit facilities or delivery points on specific unitized leases, rather than determining the location of these items solely upon considerations of maximum recovery of unit hydrocarbons and maximum efficiency of unit operations. Conversely, under these circumstances royalty owners may become reluctant to join

205. This may occur because as the reservoir continues to be depleted, the rate of depletion in one area of the reservoir may be higher than another, and engineering and geological considerations may indicate that pressure maintenance and other production techniques could be applied more advantageously to different areas of the reservoir.

in unit operations unless they are assured of the location at which the unit gas will be delivered to its purchaser. In either case, implementation of *Middleton*'s interpretation of the effect of a unit agreement upon the gas royalty clauses contained in the unitized leases is not likely to further the public policy of this State of encouraging the unitization of mineral leases.[206]

Despite these problems, it must be observed that the court's construction of the relevant provisions of the *Middleton* unitization agreement has some support in its literal terms. The agreement, after all, does provide that gas royalty settlements shall be made only in accordance with the various lease instruments and makes no reference to enlarging the scope of the gas royalty standard to apply to sales of gas occurring on and off the unit area. For that reason, the court's interpretation that the *Middleton* unitization agreement had no impact upon the gas royalty payment obligations of the *Middleton* lessees is justifiable. However, the court's interpretation was not the only construction available to apply to the provisions of the unitization agreement. In fact, an alternative interpretation of these provisions, rejected by the court, to the effect that the terms of the unitization agreement effectively amended the provisions of the gas royalty clauses contained in the unitized lease contracts to refer to gas sales made "off the unit," instead of "off the premises," and "on the unit," instead of "at the wells," seems to be a more reasonable construction of the *Middleton* unitization agreement.[207]

This form of interpretation would have given full effect to the "single lease" theory of unitization which prevails under Texas law in that the result of its implementation would have been the treatment of the entire unitized area as though it were one lease, with sales of gas delivered anywhere within the unitized area being equivalent for royalty purposes to sales "at the wells," and sales of gas delivered beyond the unit area being correspondingly equivalent to sales "off the premises." The other terms of the respective leases' gas royalty provisions, however, would have remained unaffected. Thus, for example, the basic royalty calculation

206. *See* Halbouty v. Railroad Comm'n, 163 Tex. 417, 426-27, 357 S.W.2d 364, 370 (1962); Atlantic Ref. Co. v. Railroad Comm'n, 162 Tex. 274, 278-88, 346 S.W.2d 801, 810 (1961).

207. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 251 (Tex. 1981).

formula, and its distinctions between sales of gas made on or off the leased premises, would have continued in effect. At the same time, each unit participant would have remained responsible for its own royalty payment obligations, in accordance with the mandate of the unitization agreement, by reference to the individual standards contained in its respective lease. The only modification to those lease terms would have been the substitution of the "unitized area" concept for that of the "leased premises." This form of construction would have ensured that, as modified by the unit agreement, the terms of the royalty clauses of the individual leases in existence prior to unitization would have remained in effect. In this manner, the unitization agreement and the lease agreements covered thereby would have been harmonized in a way that would have observed the legal effect of the "single lease" theory of unitization while giving full effect to the provisions of the unitization agreement relating to the calculation of royalty on gas produced from the unit area. It would have been appropriate for the *Middleton* court to have so construed the unitization agreement and leases before it. Indeed, the implementation of a unitization agreement results in a unit well being considered a constructive well on each unitized lease, and production therefrom being considered constructive production from each unitized lease, and unit operations being considered constructive operations on each unitized lease. It seems, therefore, by analogy, that the *Middleton* court could have held that the sale (i.e. delivery) of unit gas anywhere on the unit constituted a constructive sale on each unitized lease with royalty calculable on the basis of the proceeds received from such sales. The court, however, selected a different alternative; a justifiable alternative, but perhaps not the most reasonable one.

2. *Division Orders.* The *Middleton* court's treatment of the effect of executed division orders upon the amount of royalty payable under the gas royalty clauses involved presents one of the most controversial aspects of the *Middleton* decision. In *Middleton,* both Exxon and Sun asserted the existence of valid division orders signed by the royalty owners, or the predecessors of their interests, as a defense to the royalty owners' market value gas royalty claims. Each lessee claimed that these written instruments expressly modified the gas royalty clauses of their respective leases, establishing a method for calculating and paying gas royalties essentially based

upon the proceeds received from the sale of the subject gas.[208]

Sun's division orders expressly provided that they would remain in effect for the life of Sun's leases and set out a formula for use in calculating royalties on gas subject to their provisions.[209] This formula was based upon the market value of the gas, but it applied only when the gas was *not* sold at the tailgate of a processing plant. For gas sold at a processing plant, as all of Sun's gas was, Sun's division orders provided that royalty be calculated on the basis of the proceeds of the sale. Exxon's division orders, on the other hand, called for the payment of royalty either on the basis of the market value of the gas or on the proceeds received from its sale, depending upon whether the sale occurred on or off the unitized premises of which its *Middleton* leases formed a part.[210] If the sale of Exxon's gas occurred within the unit area, the amount realized from the sale served as the royalty standard; if the sale occurred beyond the unit area, the market value standard applied. Most of Exxon's gas sales occurred on the unit premises and, therefore, were governed by the "amount realized" royalty standard.

Each lessee contended that at all times royalties payable with respect to its gas had been paid, and unconditionally accepted by the royalty owners, in accordance with its division orders.[211] The lessees argued that their respective leases had been amended by the terms of their division orders and the payments made thereunder fully satisfied their royalty obligations. Alternatively, they contended that the royalty owners, having accepted the royalty payments without complaint; were estopped to claim additional royalties under their leases.[212] The royalty owners responded, contending that they were required to sign the division orders and that, therefore, the division orders were not the product of a true bargain and also were unenforceable because they were unsupported by consideration.[213]

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208. *See id.* at 249-51.

209. *See id.* at 250.

210. *See* Exxon Corp. v. Middleton, 24 Tex. Sup. Ct. J. 6, 12-15 (Oct. 4, 1980). This is the court's initial opinion in *Middleton*, which opinion was published but later withdrawn by the court.

211. *See id.* at 12-15.

212. *See id.* at 12-15.

213. *See id.* at 13.

The trial court found that Sun's division orders did not amend the gas royalty clauses of the leases and were revocable upon written notice and, in fact, had been revoked by the royalty owners upon the filing of suit.[214] The trial court also found that prior to revocation the division orders were supported by consideration, and the royalty payments tendered and accepted during that time discharged Sun's royalty obligation to that extent.[215] Such payments made and accepted after that time, however, were held not to be supported by consideration and, consequently, were not conclusive of the royalty owners' claims.[216]

The court of civil appeals held that both Sun's and Exxon's division orders constituted binding agreements supported by consideration and, therefore, were irrevocable except upon mutual agreement of the parties.[217] The court held that since Sun's division orders modified the gas royalty standards contained in its leases, Sun's payment, and the royalty owners' acceptance, of royalty tendered thereunder discharged Sun's royalty payment obligation.[218] However, the court held that Exxon's division orders did not affect its gas royalty payment obligation because they did not purport to change the royalty payment standards established in its leases.[219]

The supreme court obviously found this aspect of the *Middleton* case troublesome, writing two opinions on the case as the result of its indecision concerning the proper disposition of this issue.[220] In its initial opinion, the court characterized division orders as being intended to provide a specific and "more comfortable" method for the lessee to determine the basis upon which royalty settlements should be made, but not being intended to allow the lessee "to amend the lease, relieve [the lessee] of lease obligation, or secure advantages over the lessor which could not be asserted under the provisions of the lease."[221] In short, the court's initial opinion con-

214. Exxon Corp. v. Middleton, 613 S.W.2d 240, 250 (Tex. 1981).

215. *See id.* at 250.

216. *See id.* at 250.

217. Exxon Corp. v. Middleton, 571 S.W.2d 349, 365 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981).

218. *Id.* at 365.

219. *See id.* at 363.

220. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981); Exxon Corp. v. Middleton, 24 Tex. Sup. Ct. J. 6 (Oct. 4, 1980).

221. Exxon Corp. v. Middleton, 24 Tex. Sup. Ct. J. 6, 14 (Oct. 4, 1980). The court described division orders in this first opinion as being instruments, signed by the royalty

cluded that the terms of the division orders did not amend the gas royalty provisions of the underlying leases because they were not contracts; the contractual elements of intent, consideration, and mutuality being absent from the circumstances surrounding their execution.[222]

The court's second, and final, *Middleton* opinion wholly replaced its initial decision, but basically differed from it only with reference to the disposition of the division order issue. Focusing almost exclusively on Sun's division orders, the court made no express statement concerning whether division orders constitute binding contracts revocable only upon the mutual consent of the parties. In fact, the court completely ignored all contentions raised by the lessees on this aspect of the division order issue, stating *only* that "the Texas law has been that payments made and accepted under an agreement such as these were effective until the agreement was revoked."[223] With regard to Exxon's division orders, the court expressly held *only* that they were revoked when the royalty owners served Exxon with copies of their pleadings,[224] but implied that royalty payments made and accepted under the division orders prior to their revocation discharged Exxon's royalty obligation for the period of time covered by the payments.[225]

The court's statement in its final *Middleton* opinion concerning the nature of gas division orders and their impact upon lease royalty obligations is severely inadequate and seems to make an erroneous assessment of applicable Texas law concerning these matters. This portion of the opinion is also vague in many respects. For example, the opinion contains no genuine detailed discussion of applicable Texas law regarding gas division orders; the court

owners, which specify to whom and in what percentages the royalty allocable to the subject gas is to be paid and which are prepared for the purpose of protecting the distributor of those royalty payments from liability for improper payment. The court also correctly noted that gas royalty division orders are usually directed to the lessee as the operator of the lease, rather than the purchaser of the gas, because it is the lessee who generally receives and distributes the royalty proceeds from the sale of the gas. *See id.* at 13.

222. *See id.* at 14.

223. Exxon Corp. v. Middleton, 613 S.W.2d 240, 250 (Tex. 1981).

224. *See id.* at 250.

225. This part of the court's holding was not expressly stated in the opinion. However, because the court held that the parties were bound by the terms of the division orders for the period during which they acted under them, it seems reasonable to infer that such was the court's opinion. The terms of the court's judgment, in any event, do expressly support this proposition. *See id.* at 252.

makes only conclusory statements in this area and those statements are supported by relatively few authorities. The opinion also does not develop fully the relevant facts presented to the court on this matter, failing to quote, or at least discuss in detail, the terms of the division orders it purports to construe.[226] Correspondingly, there is no reasonable effort, within the opinion, to apply the applicable law to the facts.

This portion of the opinion at times even becomes non-sensical. For example, when the court attempts to describe Sun's division order contentions it only mentions Sun's *alternative* contention, that its division orders were at least binding upon the royalty owners for the period in which they acted under them without complaint.[227] The opinion contains no reference at all to Sun's primary argument that its division orders constituted binding agreements which irrevocably amended the terms of the gas royalty provisions contained in its *Middleton* leases. The result is an inaccurate portrayal of the contentions and issues raised in the litigation concerning the impact of executed division orders upon a mineral lessee's gas royalty obligations.

This portion of the supreme court's opinion is further confusing in that both the court's initial opinion and the opinion of the court of civil appeals contain at least some discussion of the entire division order issue.[228] In comparison to those opinions, the court's final *Middleton* opinion conveys the impression that the court deliberately chose to avoid one of the basic issues presented in the *Middleton* litigation, that being the effect upon a gas royalty lease provision of an executed division order, fully supported by consideration, having a term of equal duration with the underlying lease,

226. In fact, the opinion devotes only two sentences to Exxon's division orders, stating as a matter of law they were revoked with the service on Exxon of the *Middleton* suit papers. *See id.* at 251. There also is no effort in the opinion to compare the terms of Exxon's division orders with Sun's division orders, even though it appears they contained completely different language.

227. That this was, in fact, only an alternative position taken by Sun is evident from a comparison of the supreme court's two opinions in the case and the opinion of the court of civil appeals. *Compare* Exxon Corp. v. Middleton, 571 S.W.2d 349, 363-65 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981) *with* Exxon Corp. v. Middleton, 24 Tex. Sup. Ct. J. 6, 12-15 (Oct. 4, 1980) *and* Exxon Corp. v. Middleton, 613 S.W.2d 240, 249-51 (Tex. 1981).

228. *See* Exxon Corp. v. Middleton, 24 Tex. Sup. Ct. J. 6, 12-15 (Oct. 4, 1980); Exxon Corp. v. Middleton, 571 S.W.2d 349, 363-65 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981).

and expressly made applicable to all sales of gas produced from the lease.

The imprecise treatment of the division order issue also makes the supreme court's final *Middleton* opinion appear erroneous in some respects, especially with regard to the revocability of division orders. By their very nature, as instruments intended to describe to whom and in what proportion royalty payments are to be made, division orders require some degree of flexibility in their terms to permit changes reflecting new royalty interest owners or varying percentages of distribution for royalty monies. For this reason, many division orders contain statements making their provisions terminable at will upon written notice, thereby providing an easy means of amending their terms. With reference to division orders of this type, courts have held that the parties are bound only to the extent of royalty payments tendered and accepted thereunder prior to notice of termination.[229] In some cases, however, in order to introduce some degree of stability into royalty payment obligations, parties to division orders have agreed to gas royalty payments tendered thereunder in amounts tied to the proceeds received from gas sales under specified contracts without having the right to terminate the division orders at will.[230] Thus, division orders having terms of specified duration have been recognized in Texas.

The *Middleton* opinion fails to recognize the existence of the latter type of division order and its implications regarding the revocability or irrevocability of division orders. The only statement in the opinion *expressly* concerning the revocability of a division order is that made with reference to Exxon's division orders, and it simply pronounces that Exxon's division orders, as a matter of law, were revoked simultaneously with the service of the *Middleton* suit papers on Exxon. It is not clear from the opinion whether the trial

229. *See* Chicago Corp. v. Wall, 156 Tex. 217, 221-22, 293 S.W.2d 884, 846-47 (1956).

230. This form of division order was involved in *Union Producing Co. v. Driskell,* 117 F.2d 229 (5th Cir. 1941). There the parties, by division order, had agreed that royalty due on gas produced from the lease involved would be based on the sales price of the gas as determined under the gas sale contract between the lessee and a third party to whom the gas was sold. The lessor later disputed the effect of the division order, but the court held "[w]e know of no principle upon which competent persons who have agreed upon a fixed price can after accepting it for some years, repudiate the agreement and claim more, merely because they think the price was too low." *Id.* at 231.

court found that Exxon's division orders were not supported by independent consideration. It is likewise unclear whether Exxon's division orders were expressly made terminable at will upon written notice. Only if one assumes the absence of independent consideration does the court's statement regarding the revocability of Exxon's division orders make sense. In such circumstances the court's statement would accurately reflect accepted common law that a contract unsupported by consideration is not binding at all, and yet would give effect to the equitable principle of estoppel, binding the parties to their conduct which was intended to induce, and did induce, reasonable reliance thereon by another. Unless the division orders were made terminable at will, the court's position would be incorrect.

This portion of the court's opinion becomes completely illogical when applied to Sun's division orders. The supreme court made no express statement concerning the revocability of Sun's division orders. Thus, it must be presumed that the court's statement regarding the revocability of Exxon's division orders also was intended to be applicable to Sun's division orders. Such an explanation might have been satisfactory if Sun's division orders were silent with respect to the length of their term or if they had specified that their provisions were terminable at will. This explanation is inappropriate here, however, because it fails to recognize that Sun's division orders expressly provided that their terms would remain in effect for the life of the lease. The court's failure to discuss this issue in depth amounts to an error of grievous proportions in light of the trial court's express finding, unchallenged on appeal and expressly affirmed by the court of civil appeals, that Sun's division orders were supported by consideration. These distinctions among Sun's and Exxon's division orders render inapplicable to Sun the court's pronouncement that Exxon's division orders were revoked as a matter of law upon service of the *Middleton* suit papers on Exxon. Thus, the court must face the very real problem that in *Middleton* it declared a division order, a contractual agreement between a mineral lessee and royalty owner, which was supported by consideration and had an express term of equal duration with the underlying mineral lease, revocable at the will of either party. The effect of this conclusion, in terms of established contract law, is incomprehensible. The court could not have intended this result.

Reduced to its most simple form, the proposition must be that a division order is either a contract binding upon the parties and revocable only by mutual agreement of the parties, or it is not. If the express terms of the division order made it revocable at will upon written notice, the proper resolution of the issue is clear; the express terms of the division order should be declared dispositive of the matter. Likewise, if the division order is found not to be supported by independent consideration, it can only be binding to the extent that the parties have accepted its terms and acted thereunder without complaint, thereby producing some form of ratification or estoppel. In any event, it should be clear that a division order supported by independent consideration, no matter how slight,[231] is a binding contract just as any agreement and should be enforced in accordance with the intent of the parties, as embodied in the division order's express terms.

In *Middleton,* every element of a contract existed in Sun's division orders, if not in Exxon's. The trial court found that Sun's royalty owners deliberately entered into the division orders in 1952.[232] The proposal set forth therein for the calculation of royalty payable on gas produced under Sun's leases, according to the reported opinions, was accepted by the parties and Sun, in reliance thereon, calculated and paid royalties which were received by the royalty owners without objection for more than twenty years.[233] Moreover, as found by the trial court, in these division orders Sun agreed to perform additional duties which it theretofore had not been obligated to do. The division orders contained an express provision making them effective for the life of the underlying lease. The provisions of these division orders are clear; no contention of ambiguity with respect to them appears in the court's opinion. Since the elements of a valid and binding agrement apparently existed with

231. *See* City of Beaumont v. Fertitta, 415 S.W.2d 902, 907 (Tex. 1967); Wright v. Donaubauer, 137 Tex. 473, 478, 154 S.W.2d 637, 640 (1939); 1 S. Williston, Contracts § 121 (3d ed. 1957); Restatement of Contracts § 84(c) (1932). Furthermore, the court's holding in its initial opinion that a division order is not a contract conflicts with several Texas cases dealing with that subject. *See, e.g.,* Chicago Corp. v. Wall, 156 Tex. 217, 221, 293 S.W.2d 844, 846 (1956); Koenning v. Manco Corp., 521 S.W.2d 691, 699 (Tex. Civ. App.—Corpus Christi), *writ ref'd n.r.e. per curiam,* 531 S.W.2d 805 (1975); Pan American Petroleum Corp. v. Vines, 459 S.W.2d 911, 912 (Tex. Civ. App.—Tyler 1970, no writ); Le Cuno Oil Co. v. Smith, 306 S.W.2d 190, 192 (Tex. Civ. App—Texarkana 1955, writ ref'd n.r.e.).

232. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 249-50 (Tex. 1981).

233. *See id.* at 249-50.

respect to these division orders it is puzzling why the *Middleton* court did not enforce them in accordance with their terms.

Certainly the *Middleton* Court could not have based its decision on the *Butler* opinion or the district court opinions in *Kingery* or *Brent*. None of these recent *Vela*-type cases were cited in *Middleton*'s disposition of the division order issue. Moreover, although each of those decisions rejected the division order defenses posed to the market value gas royalty claims presented there, each is distinguishable from the situation presented in *Middleton*. In *Butler*, unlike *Middleton*, there was no finding of independent consideration to support the division orders involved there, nor was there a finding of reliance by the lessee upon the terms of the division orders.[234]

The district court opinions in *Kingery* and *Brent*, later superseded by the Fifth Circuit opinion in the consolidated appeals of those cases, are also distinguishable from *Middleton*. In *Kingery* the division orders, by their express terms, applied only to sales of gas made pursuant to a single, specified gas sale contract. The district court decision in *Kingery* properly held that the royalty owners were not entitled to additional royalty on gas covered by the division orders, but could recover additional royalty on all other gas subject to their leases.[235] In *Middleton*, of course, the division orders were not limited to gas sold under specific contracts and hence the *Kingery* district court opinion does not have precedential value. In *Brent*, the parties had never really observed or adhered to the provisions of their division orders; therefore, the district court had little difficulty in disregarding its terms.[236] Once again, this presents a distinguishable situation from that presented in *Middleton* where it was established that the parties had always paid and accepted royalties calculated on the basis of the provisions of their division orders.

Thus, there appears to be no rational basis for the *Middleton* court's division order analysis. Unfortunately, this part of the *Middleton* decision stands as the current Texas law on the subject and

234. *Compare* Butler v. Exxon Corp., 559 S.W.2d 410, 416-17 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) *with* Exxon Corp. v. Middleton, 613 S.W.2d 240, 250 (Tex. 1981).

235. *See* Kingery v. Continental Oil Co., 434 F. Supp. 349, 355-56 (W.D. Tex. 1977), *rev'd*, 626 F.2d 1261 (5th Cir. 1980).

236. *See* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 159 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980).

undoubtedly will be the cause of future litigation concerning the effect of division orders upon a mineral lessee's gas royalty payment obligations.

C. *Determining the Market Value of Gas.*

The major focus of the *Middleton* decision was, of course, the proper determination of the market value of the gas involved. Having determined that the subject gas had been sold "off the premises," rather than "at the wells," and that the royalty thereon was determinable by reference to the market value of that gas, rather than the proceeds derived from its sale, the court shifted its attention to the matter of how the market value of gas committed to be sold under long-term gas contracts ought to be calculated. All parties to the *Middleton* case agreed that the market value of the subject gas should be fixed as of the date of its sale; thus, the initial inquiry for the court became: when is gas that is dedicated to a long-term sale contract sold?

1. *When is Gas Sold?* In response to this issue, the Texas Supreme Court affirmed its holding in *Vela* that gas subject to a long-term sale agreement is sold with each delivery of gas to the purchaser, and that the market value of gas under the subject royalty clauses, therefore, is determinable afresh with each delivery.[237] The court rejected the contention of the *Middleton* lessees that gas is sold under a long-term contract at the time the contract under which it is sold became effective. The court noted that under the gas royalty clauses, royalty did not become payable until the gas was "*produced* from said land and sold or used off the premises,"[238] and concluded that the effective date of the gas sale contracts could not govern the diposition of this issue because these contracts became effective long before gas was produced under these leases.[239] Since the gas was not being produced on the effective date of the gas sale contract, the court considered that the gas was not "sold" at that time and that the market value of gas on that date was immaterial to its determination of the market value of the gas. The court held that under the royalty clauses, gas is "sold" at the same time it is "used," and since gas is not "used"

237. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 245-46 (Tex. 1981).
238. *Id.* at 245 (emphasis by the court).
239. *See id.* at 245.

until it is delivered, likewise it is not "sold" until it is delivered.[240]

The *Middleton* court's holding on this issue seems inconsistent with gas marketing realities and the probable intent of the parties to the *Middleton* leases. Initially, it must be observed that concepts of gas production and delivery arguably are not relevant to a determination of when gas is "sold" in relation to a market value gas royalty claim, particularly as to the *Middleton* royalty clauses. The term "production" in the *Middleton* royalty clauses is significant only in the sense it specifies that royalty is due and payable on gas that has, in fact, been extracted from the ground. This provision simply distinguishes gas actually produced from the leasehold's known, provable reserves which have not yet been produced and, arguably, is descriptive only of that gas which carries a royalty payment obligation.

Likewise, the concept that a sale of gas occurs only with its delivery, while perhaps applicable in other contexts, seems inappropriate for determining the market value of gas sold under a long-term contract. As is often true of other terms, the exact meaning of the word "sold," as used in a given instrument, depends upon the nature of the instrument and the context in which the word appears therein. Sometimes it may be intended to include both the element of a binding contract, plus delivery of the items covered thereby, while at other times it may refer only to a binding contract without such a delivery. For example, the delivery of property or goods under an executory contract of sale marks the time when the executory contract of sale has become a fully executed contract.[241] This distinction becomes significant when determining

240. *See id.* at 245.

241. An executory contract, of course, is one with respect to which performance has not yet been completed; that is, it is a contract as to which something remains undone. An executed contract is one under which performance has been completed. In a contract for the sale of goods, delivery of those goods is the test for determining whether the contract is executory or executed and whether, as a consequence thereof, *title* to the goods has passed. This was the subject of examination in *Martin v. Amis*, 288 S.W. 431 (Tex. Comm'n App. 1926, judgment adopted), the sole authority cited by the court in *Vela* as support for its holding that gas is sold under a long-term contract only upon delivery. In the context of *Martin v. Amis* it was necessary for the court to determine when and where the executory gas contract became executed and the title to the gas thereby passed. The court held that these particular events occurred upon delivery of the gas. *See id.* at 433. Such a determination, however, does not even reach the question arising under the gas royalty clause in *Middleton* as to when the gas is considered as *sold* within the meaning of the clause. That determination should depend entirely upon the mutual intention of the parties and should

the time at which the items covered by the contract are "sold" for purposes of determining who, as between the buyer and seller, has legal title to the items. In the *Vela* claim context, however, the title to the gas is not in dispute and the controversy is not between the buyer and the seller of the gas. Instead, the matter of concern is the amount of money that reflects the economic value of a particular reserve of gas dedicated to sale under a long-term contract. The significant difference in the nature of these issues is at least some indication that the royalty owners and the lessees did not intend, in the gas royalty clause relating to the market value at the well of the gas "sold," to observe the technical distinction between an executed gas sale contract and a binding contract to deliver gas in the future. Thus, the concepts relied upon by the *Middleton* court in resolving the issue of when gas is "sold" under a long-term gas sale agreement seem ill-suited to the task. In this case, it seems that a broader definition of the term "sold," one based upon the parties' intention as determined from all the relevant circumstances, would have afforded a more appropriate base from which to analyze the issue.

The basic principle which should have guided the court in determining when gas is sold is that the lease provisions should be construed to reflect the mutual intention of the parties in providing that the royalty on gas should be the market value of one-eighth of the gas sold. That is, did the parties mutually intend that the royalties on the gas involved would be one-eighth of the market value of gas of like quality sold in the market area and computed afresh each day, month, or quarter with each delivery of gas to its purchaser, or did the parties, perhaps, intend something else? In determining this intent, the court should have devoted some attention to the meaning attached to the trade customs of the gas industry as reflective of the parties' intent because it was within that context that the lease was entered into by them.[242]

The marketing customs of the gas industry demonstrate that there has never been a period when a "posted price" technique,

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not necessarily coincide with the execution of the contract obligation or the delivery of the gas and the passage of title.

242. *See* Wolfe v. Schuster, 591 S.W.2d 926, 930 (Tex. Civ. App.—Dallas 1979, no writ) (construction of a note); Fleming v. Todd, 42 S.W.2d 123, 127 (Tex. Civ. App.—Beaumont 1931, writ dism'd) (construction of vendor's lien note).

such as that found in the oil industry, has been used in the marketing of natural gas. Correspondingly, there has never been a convenient price bulletin for the gas industry in which a market value for gas can readily be found. Rather, the only way gas has been marketed is pursuant to long-term contracts[243] which assume a wide variety of forms and are not susceptible to the kind of categorization required to produce a ready-made posted price marketing mechanism. This, coupled with the wide variances from field to field of wellhead pressures, producible reserves, quality of gas and other factors bearing upon the price of gas, requires that a determination of market value of gas derived from comparable sales and made afresh for each measureable period involved be based upon an examination of literally thousands of production records by expert witnesses. Contrary to the holding of the *Middleton* court, it seems unreasonable to think that the parties to the *Middleton* leases, or any other comparable oil, gas, and mineral leases, would have intended that such a complex and expensive method be used to compute the gas royalty payments due thereunder. In the absence of an indisputable expression of intent by the parties that the gas royalties should be so calculated the court should have presumed that it was not the mutual intention to use such an impractical standard for calculating gas royalties.

The *Middleton* lessees' suggestion that the word "sold" as used in the parties' market value royalty standard was intended by the parties to refer to the time at which the subject gas became committed for sale under the long-term contract, although rejected by the court, seems to be a more reasonable interpretation of this clause. Under this approach, the market value of gas would have been determined as of the time that the long-term contract was made and would have properly formed the basis for royalty payments under the market value standard if the contract price fairly represented the market value of the subject gas at the time the contract was made. In this context, the contract price would be viewed as the proper measure of the market value of the gas, *not* because it is the actual selling price of the gas, but because the price would, by happenstance, also represent the market value of the gas at the time when it irrevocably was committed to be sold.

This method seems to present a sensible approach to the issue

243. See notes 13-14 *supra* and accompanying text.

because the time at which the gas is *committed and dedicated* to a specific purchaser under a long-term contract is the time when the gas is truly disposed of. The gas is disposed of at this point in time because it is then that the parties to the contract have bound themselves to a sale of the gas at a specified price to a specified purchaser and the gas thus committed is taken off the market for the duration of the contract. It is only logical to assume that the lessors and lessees under such a royalty clause would have considered the gas covered by its terms to have been "sold" as soon as a binding agreement, whether technically executed or executory, had been entered into investing the gas purchaser with the right to demand delivery of the gas during the full term of the contract. This is exactly the legal result of a lessee entering into a long-term gas sale contract. In such circumstances the lessee effectively has bound itself to deliver all of the gas covered by the contract to the buyer for the duration of the contract at the price specified therein, failing which it will be liable in damages. With the terms and conditions of the sale fixed at the time the long-term contract is entered into, it seems clear that the gas, in fact, has been sold at that point, and it is then that the market value determination with respect to the gas appropriately may be made.

Had it adopted this analysis, the *Middleton* court could have more reasonably concluded that gas is "sold" under a long-term contract at the time when the contract under which it is sold was executed. Such a construction would have been a more rational one than that selected by the court; it certainly would have been more consistent with industry custom and the practical, business fact that gas sold under an executory contract of sale is committed unconditionally to sale at the time the contract is made.

2. *How is the Market Value of Gas to be Determined?* The portion of the *Middleton* opinion dealing with how the market value of gas committed for sale under a long-term contract is to be determined is fraught with internal inconsistencies and premised upon standards which will necessarily promote future litigation in this area of the law. In addition, this part of the court's opinion is the product of a distorted, if not illusory, view of gas marketing. All of these deficiencies render the propriety of this aspect of the *Middleton* decision highly qustionable.

Initially, it should be observed that this portion of the *Middleton* opinion simply holds that the market value of gas made the subject of a *Vela* claim is to be established by expert testimony, that all such expert testimony is to be considered in all cases by the fact finder, and that objections to the basis of such testimony are merely to be considered by the fact finder as bearing upon the weight to be accorded that testimony, not as barring its admissibility.[244] The problem with this "standard" of measuring royalty payment obligations is that, in reality, it is no standard at all. Mineral lessees and lessors, hopeful that the court would provide some sort of definitive guideline by which they could gauge and formulate their future gas royalty payment rights and duties, do not know any more about these matters now than before the court issued its decision in *Middleton.* Indeed, all that is known about this subject with any degree of certainty is that the determination of the market value of gas committed for sale under a long term contract will be made by the fact finder based upon evidence of comparable sales of gas. This is hardly an acceptable basis upon which to premise one's calculation of royalty due upon gas production subject to a "market value" gas royalty clause and the ultimate effect of this part of *Middleton* surely will generate future litigation concerning the market value of gas.

The precise method indulged by the *Middleton* court for calculating the market value of gas, insofar as it purports to set a standard for this type of litigation, is also subject to criticism. The rule announced by the *Middleton* court in this regard is, in effect, a rule of "daily sales" in which the market value of gas is determined on the basis of the most recent contracts entered into in the marketing area covering gas comparable in quality and availability to market outlets. There is no way in which any producer can sell its gas so as to obtain *Middleton's* conception of its market value. Gas is not, and cannot be, sold on a daily basis or even on a short term basis.[245] The size of the marketing investment necessary to market gas precludes its sale on a "spot market" basis and requires the commitment of the gas under a long-term contract. The buyer of gas would not make a purchase on a daily or monthly basis at any

244. Exxon Corp. v. Middleton, 613 S.W.2d 240, 249 (Tex. 1981).

245. This information is contained in the court of civil appeals opinion in *Middleton* which provides a good discussion of the historical background of these *Vela*-type controversies. *See* Exxon Corp. v. Middleton, 571 S.W.2d 349, 352 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981).

price unless in an extreme emergency.

Even if a producer could make a long-term contract for the sale of its gas at a price equal to the highest price most recently paid in the relevant marketing area for comparable gas, under the *Middleton* rule the producer could only be assured that its gas was being sold at market value on the day first deliveries of the gas occurred. There would be no way to know that on the following day, or the following month, the price being received by that producer under its contract would still represent the market value of the gas at that time, because in the interim higher priced contracts for comparable gas in the marketing area could have been entered into by others. Furthermore, the method approved by the court in *Middleton,* if carried to its logical conclusion, may result in producers being required to pay more in royalty than they receive for the entire production from a well. On the other hand, the *Middleton* rule could entitle the producer to account to its royalty owners on the basis of an amount less than that actually received for the sale of the gas. The former situation would occur, as currently is often true, when the market price of gas exceeds the contract price of the gas, whereas the latter situation would arise in a declining market situation. Such potential results seem entirely inconsistent with what must have been the true intent of the parties and yet, these results must be recognized as the logical extension of the *Middleton* court's rule.

The court's rule of "daily sales," and the results which may be hypothesized from its implementation, are an outgrowth of one of the basic precepts of the *Middleton* opinion, that in a market value royalty claim, "gas should be valued as though it is free and available for sale."[246] In this respect, the court indulged in sheer fantasy. The object of a court required to resolve a *Vela* claim should be the determination of the market value of the particular volume of gas in question and that determination should be based upon the peculiar circumstances of *that* gas, including its commitment for sale under a long-term contract. If the gas is committed and not available for sale, then it should not be theorized to be, or valued, otherwise. To do so simply hinders the effort to find the true market value of that particular volume of gas. In the case of committed gas, its market value should be determined by reference

246. Exxon Corp. v. Middleton, 613 S.W.2d 240, 247 (Tex. 1981).

to sales of gas of comparable quality, quantity, and legal character which also has been committed for sale under a contract having a comparable term. Failing to recognize and account for the committed nature of the gas simply results in the valuation of an actual, existing volume of gas pursuant to a theoretical standard which in no way reflects any of the genuine circumstances of that gas.[247]

The *Middleton* court's approval of assessing the market value of gas on the basis of the average of only the three highest priced sales of comparable gas in the relevant market area likewise yields unreasonable results. Because this method only averages the highest priced sales of comparable gas in the area, the seller of the highest priced gas to which the *Middleton* gas was compared effectively received more than market value for his gas while the other sellers of gas in that area who sold gas at less than the average of the three highest prices received less than market value for their gas.[248] Moreover, because this type of calculation is limited to "fresh sales" of gas in a particular month or calendar quarter, and because the market value of gas as determined under this method may continually shift from period to period, the one seller who did receive at least market value for its gas, may easily not receive market value for such gas in the following month or calendar quarter.

Averaging the three highest prices of comparable gas as a method of calculating the market value of gas is also inconsistent with the court's own concept of when a sale of gas is made and its notion of what gas sales are comparable in time. The *Middleton* court held that a sale of gas is made with each delivery of gas.[249] The court further held that the market value of gas is to be ascer-

247. *See* First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783, 786 (Tex. Civ. App.—El Paso 1980, writ granted) (real, actual monetary award not theoretical market value determination is the issue).

248. Indeed, in *Middleton* it was apparent that no producer in the Anahuac Field ever received the price which, in the opinion of the royalty owners' expert witness, constituted the market value of the subject gas. Moreover, the market price "established" by this expert's testimony was rarely received in sales made in the entire marketing area upon which his testimony focused. In fact, no one in Railroad Commission District Nos. 2, 3, and 4 ever received this witness's opinion of market value for gas in that area for more than one calendar quarter. *See* Exxon Corporation's Application for Writ of Error at 37. This, of course, illustrates another of the potentially absurd results which may be produced by the *Middleton* opinion.

249. Exxon Corp. v. Middleton, 613 S.W.2d 240, 245 (Tex. 1981).

tained by reference to all sales of gas of comparable quality which are comparable in time, defining that phrase to mean sales of gas that occur contemporaneously with the sale of gas in question.[250] All gas that is being produced, however, by its very nature is delivered each day because gas is constantly flowing or being pumped into the pipeline of its purchaser. Because a sale of gas is made with each delivery, all gas being produced from a given market area is being sold every day. Therefore, all deliveries of gas in a given market area constitute sales of gas that are comparable in time to the gas in that market area which is the subject of the market valuation study. Thus, even assuming that the *Middleton-Vela* test is appropriate for determining the market value of gas, the selective averaging of only the three highest priced sales of comparable gas sold in the market area is clearly an inappropriate device for the implementation of this test because it excludes from consideration some sales of comparable gas from the market value determination.

In order to ascertain the true market value of a specific volume of gas using the *Middleton-Vela* test, all evidence of the market value of that gas, and, therefore, all sales of gas comparable in time to sales of the subject gas (which are also otherwise comparable in terms of quality and quantity) should be considered. The selective averaging of only the three highest priced sales of comparable gas fails to accomplish this objective and for that reason is unacceptable. Indeed, the only method which would account for all sales of otherwise comparable gas which are also comparable in time, would be a volume-weighted average price method which would include the price of all comparable gas delivered in the market area. Certainly, this would be a more realistic appraisal of the market value of a large volume of flowing gas of comparable quality than the restricted average method approved by the *Middleton* court. In fact, it only makes sense that a volume-weighted average price of all comparable gas sold in a given period would more closely reflect the market value of a given volume of gas than would a selective arithmetic average of the three highest priced sales of such gas.

The *Middleton* court attempted to justify its approval of the selective averaging method utilized by the royalty owners on the basis that the gas prices were constantly increasing during the period

250. *Id.* at 247.

involved and, therefore, the most current market value for this gas would necessarily be reflected by the highest priced gas that was comparable in all other respects.[251] This reasoning, however, begs the question. The court's obligation in market value gas royalty claims is not to find the highest priced comparable gas sold in the market area and declare the price of that gas to be the market value of all comparable gas. Rather, the court should direct its attention to determining the true market value of the particular volume of gas involved, based upon a comparison of *all* sales of *all* gas sold in the relevant market area having comparable quality, quantity, legal characteristics, and market commitment.

V. MATTERS NOT FULLY ADDRESSED IN *Middleton*

Some matters bearing upon the proper determination of the market value of gas committed for sale under a long-term contract were not expressly addressed in *Middleton,* but deserve some discussion here. These matters include the propriety of considering affiliate sales in various aspects of market value gas royalty claims, and the impact of applicable federal statutes and regulations upon establishing the market value of gas involved in such claims.

A. *Affiliate Sales.*

The propriety of including affiliate sales in calculating the market value of gas, although mentioned, was not fully addressed, by the Houston Court of Civil Appeals in its *Middleton* opinion[252] and was not even referred to by the Texas Supreme Court in its *Middleton* decision. Because gas produced by most major petroleum companies often is made the subject of an affiliate sale, this matter assumes a degree of significant importance.

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251. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 248 (Tex. 1981).

252. In this regard, the court of civil appeals stated:

> Furthermore, Hudson correctly declined to consider sales in which the seller was an affiliate of the purchaser because he felt that such sales might not be arm's-length transactions. It would be manifestly unjust for a lessee to sell gas to a subsidiary or to an affiliated firm, person or corporation for a low price and allow that company to extract a larger price in the resale of such product. To allow a lessee to pay royalty out of a *shallow pocket* while receiving proceeds in a *deep pocket* would be intolerable.

Exxon Corp. v. Middleton, 571 S.W.2d 349, 358 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981).

An affiliate sale of gas, of course, is one in which both the buyer and the seller of the gas are effectively associated under, direct or indirect, common ownership or control.[253] It is not uncommon, in the case of a producer of gas who is part of a major, integrated petroleum company, for the producer to sell its gas production to another arm of the integrated company for transportation, processing, or other purposes.[254] If such circumstances are present in the context of a market value gas royalty claim, an issue may be raised concerning whether those affiliate sales properly may be considered for any purpose in the litigation. This issue could arise in determining whether the affiliate sale may be considered in calculating the market value of the subject gas or in determining whether the affiliate sale may be considered in ascertaining if the subject gas is being sold "at the well" or "off the premises."

The obvious problem in considering affiliate sales for any purpose in a market value gas royalty claim is the risk that they may not constitute *bona fide* sales at all. In terms of a market value calculation, consideration of a sale that is not a *bona fide* sale, that is, one with respect to which the price or other terms were fixed by less than arm's-length bargaining, would tend to prevent an accurate determination of the true market price valuation of the subject gas. If the affiliate sale was priced at an unreasonably low level, consideration of the sale would drive down the resulting market price valuation of the gas; conversely, if the affiliate sale is priced at an unreasonably high level, the market value of the gas would be driven up. One solution to this dilemma would be the complete exclusion of all affiliate sales from these calculations. However, if the affiliate sale was made at arm's-length, the price charged for the gas in such a sale would be as accurate an indication of the market value of the subject gas as any other sale, provided the other criteria of comparability are also present in the affiliate sale. As an alternative to the complete exclusion of affiliate sales from a market value determination, it is suggested that affiliate sales be included in such market value calculations if the affili-

253. *See id.* at 358; 15 U.S.C. § 3301 (27) (1978).

254. This *would* have been the case with the portion of Exxon's *Middleton* gas that was ultimately sold to various industrial customers, had this gas actually been sold by Exxon's producing affiliate to the Exxon Gas System, the company's transportation facility. In reality, the Exxon gas was not sold at this point. Rather, this gas was sold to the customers, and royalty was paid on the basis of Exxon's field price.

ate sale is made at a price which is reasonable in light of the prices charged in other non-affiliate gas sales in the market area. Under those circumstances, the affiliate sale could be deemed to be an arm's-length sale, and the price charged therein could be considered in ascertaining the market value of the subject gas. If, however, the affiliate sale deviates from these guidelines, the arm's-length nature of the sale would become suspect and the sale would necessarily be excluded from consideration.

The effect of including or excluding affiliate sales in determining the market value of gas may not always be significant. If, as suggested, the criterion for including or excluding these sales in a market value determination of gas is the reasonableness of the price charged in such sales in relation to the prices charged in non-affiliate sales, the impact of the inclusion or exclusion of the affiliate sales often would be minimal. This logically follows because the pricing of the "reasonable" affiliate sales would closely approximate the pricing of the other sales of comparable gas being considered in calculating the market value of the gas.

The effect of excluding affiliate sales from consideration in determining whether the subject gas is being sold "at the well" or "off the premises," in the context of a market value gas royalty claim, however, could be substantial. For example, if gas which is the subject of a market value royalty claim is being sold on the leased premises, it clearly would be sold "at the well" within the meaning assigned that phrase by the *Middleton* court.[255] This would entitle the producer-lessee, having a royalty obligation governed by provisions similar to those contained in the *Middleton* lease to pay royalty on such gas on the basis of the proceeds received from the sale. If, however, the only sale "at the well" is an affiliate sale, and affiliate sales are excluded from consideration for all purposes in litigation of this type, then, under a *Middleton* royalty clause, the subject gas necessarily would be found not to have been sold "at the well," but rather to have been sold "off the premises." The significance of such a result would be the difference between calculating royalty due on such gas sales on the basis of the proceeds received from the sale of the gas and making this calculation on the basis of the market value of the gas. In terms of a pro-

255. *See* Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex. 1981) (sold "at the well" means sold at well within leased premises).

ducer-lessee's monetary royalty obligation, the impact could be staggering.

The problem posed by this aspect of the affiliate sale issue could also be resolved by reference to the reasonableness of the terms of the affiliate sale. Certainly affiliate sales made on the basis of terms which are unreasonable in light of the terms of non-affiliate sales of comparable gas in the same market area should not be considered in determining whether the gas involved is being sold "at the wells," because of the possibility that such sales may not be *bona fide* transactions. But, as with market value calculations, there appears to be no reason to exclude affiliate sales from consideration solely because the parties to the transaction are affiliates. If the affiliate sales, in all respects, are reasonable when compared to non-affiliate sales of comparable gas, there is no legitimate reason to exclude them from consideration in determining whether the gas involved is being sold "at the well" or "off the premises." To do otherwise would needlessly penalize the producer-lessee who, for legitimate business reasons, is selling its gas to an affiliate.

B. *The Impact of the Natural Gas Policy Act of 1978 Upon Market Value Gas Royalty Determinations.*

The determination of the market value of gas subject to federal regulation has been addressed to some degree by several courts applying Texas law.[256] In each instance, however, the litigation involved a determination of the market value of gas sold prior to December 1978, thereby indicating that only the terms of the Natural Gas Act,[257] and not the provisions of the Natural Gas Policy Act of 1978 (NGPA),[258] had a bearing upon the market value determination. Moreover, in each instance the courts appeared to face only the issue of whether interstate gas sales are comparable in quality to intrastate gas sales, for purposes of applying the *Vela* market value determination test.[259] As a result, these decisions

256. *See, e.g.*, Kingery v. Continental Oil Co., 626 F.2d 1261, 1264-65 (5th Cir. 1980); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978); First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783, 786 (Tex. Civ. App.—El Paso 1980, writ granted).

257. 15 U.S.C. §§ 717-717w (1938).

258. 15 U.S.C. §§ 3301-3432 (1978). The effective date of the NGPA was December 1, 1978. *See id.* § 3301; 18 C.F.R. § 270.103 (1980).

259. *See, e.g.*, Kingery v. Continental Oil Co., 626 F.2d 1261, 1264 (5th Cir. 1980) (sales in intrastate market are not comparable to sales in interstate market in determining market

have been helpful only to the extent they have informed litigants that the market value of gas subject to the terms of the Natural Gas Act may not be ascertained by reference to sales of gas made in the intrastate market, and further, to the extent they have demonstrated any computational method for deriving the market value of such comparable gas. The very distinct issue of how to calculate the market value of gas subject to the NGPA pricing provisions remains unaddressed by Texas courts.

The NGPA is a statute enacted by Congress for the stated purpose of encouraging natural gas production without providing windfall profits to producers or gas transmission companies.[260] This statute, for the first time, placed sales of all gas, intrastate and interstate, under Federal price regulations.[261] In an effort to accomplish its dual objectives, the NGPA has established numerous separate categories of gas for pricing purposes.[262] Collectively,

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value of gas); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978) (interstate prices are not comparable to intrastate prices); First Nat'l Bank in Weatherford v. Exxon Corp., 597 S.W.2d 783, 786 (Tex. Civ. App.—El Paso 1980, writ granted) (evidence of federally regulated price not admissible as comparable to intrastate price).

260. *See* 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).

261. *See* INTERIM REGULATIONS IMPLEMENTING THE NATURAL GAS POLICY ACT OF 1978, 43 Fed. Reg. 56,448, 56,451 (1978).

262. *Id.* at 56,452-56,453. *See* Natural Gas Policy Act of 1978, §§ 102-109, 15 U.S.C. §§ 3312-3319; 18 C.F.R. §§ 271.101-.904 (1980). These categories include separate classifications for new gas, gas produced from new onshore production wells, gas sold in interstate commerce prior to the effective date of the NGPA, gas sold in intrastate commerce, gas produced from deep wells, or tight sand formations, or for gas produced in small quantities from nearly depleted wells. *See* Natural Gas Policy Act of 1978, §§ 102-108, 15 U.S.C. §§ 3312-3318; 18 C.F.R. §§ 271.101-.807 (1980). While the NGPA implemented new pricing categories aimed at eliciting new supplies of gas, it left virtually intact the old pricing structure for interstate gas which was being sold under the Natural Gas Act on the date of enactment of the NGPA. This is accomplished by section 104 of the NGPA which applies to all sales of gas dedicated to interstate commerce prior to November 9, 1978, the date of NGPA's enactment. *See* Natural Gas Policy Act of 1978, § 104, 15 U.S.C. § 3314; 18 C.F.R. §§ 271.501-.505 (1980).

Under the Natural Gas Act, the FPC had established several different price ceilings applicable to various categories of gas committed to interstate commerce, depending upon the vintage of the gas production involved. For example, in Opinion 699-H, the FPC established a ceiling price of 50¢ per Mcf for gas produced from wells commenced on or after January 1, 1973, such ceiling price to escalate 1¢ per Mcf per year. *See* FPC Op. No. 699, Doc. No. R-389-B (1974), *aff'd,* Shell Oil Co. v. FPC, 520 F.2d 1061 (5th Cir. 1975), *cert. denied,* 426 U.S. 941 (1976). Later, the FPC increased the ceiling price for gas produced from wells commenced in 1973 and 1974 to 93¢ per Mcf, such price also to escalate 1¢ per Mcf per year, and established a price ceiling of $1.42 per Mcf for gas produced from wells these categories account for all domestic gas production. Each category of gas has its own base ceiling price and provides for various price changes and adjustments to that ceiling price including monthly changes based on an inflation factor.[263] The system of pricing is complex, requiring the participation of state agencies in its administration and the consideration of multiple factors and procedures in its application. One factor, however, remains constant under the NGPA—it is unlawful to sell gas at any price higher than the maximum lawful price assigned to the category for which the gas actually qualifies.[264]

For market value gas royalty claim purposes, the importance of the NGPA rests with its obliteration of the jurisdictional distinction between intrastate and interstate gas; under NGPA, all gas now is sold within a regulated market.[265] Thus, in the context of market value gas royalty claims, the problem regarding gas sold after December 1978 is simply ascertaining the market value of price-controlled gas.

As an initial proposition, it seems that to speak of the "market value" of price-controlled gas is a contradiction in terms. Indeed,

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commenced on or after January 1, 1975, with this ceiling price to escalate 1¢ per Mcf per calendar quarter. *See* FPC Op. Nos. 770 and 770-A, Doc. No. RM 75-14 (1976), *aff'd,* APGA v. FPC, 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied,* 435 U.S. 907 (1978). Still other price ceilings in effect under the Natural Gas Act were various area rate price ceilings which applied to gas produced from wells commenced prior to January 1, 1973. *See, e.g.,* Area Rate Proceeding (Permian Basin Area II), 50 F.P.C. 390, 400-01 (1973). The area rate structure applicable to such gas, however, was supplanted by a national ceiling rate which applied to such gas until the NGPA price ceilings came into effect on December 1, 1978. *See* FPC Op. Nos. 749, 749-A, 749-B, 749-C (1976), *aff'd in part, rev'd in part sub nom.* Tenneco Oil Co. v. FERC, 571 F.2d 834 (5th Cir. 1978), *cert. dismissed,* 439 U.S. 801 (1978). The national ceiling rate was 29½¢ per Mcf. All of the Natural Gas Act ceiling prices were adjusted in accordance with the Btu content and value of the gas. It is this price vintaging structure which is preserved under section 104 of the NGPA, with the proviso that such prices are to be adjusted monthly in accordance with an inflation factor. *See* Natural Gas Policy Act of 1978, § 104, 15 U.S.C. § 3314. Additionally, section 105 of the NGPA provides that the contract price for intrastate gas shall remain the maximum lawful price for intrastate gas subject to its terms, as increased by the applicable inflation factor. *See* Natural Gas Policy Act of 1978, § 105, 15 U.S.C. § 3315.

263. *See* Natural Gas Policy Act of 1978, §§ 102-108, 15 U.S.C. §§ 3312-3318.

264. *See* Natural Gas Policy Act of 1978, § 101, 15 U.S.C. § 3311; 18 C.F.R. § 271.101 (1980).

265. Natural Gas Policy Act of 1978, §§ 101-109, 15 U.S.C. §§ 3311-3319. *See* Federal Energy Regulatory Comm'n v. Pennzoil Producing Co., 439 U.S. 511, 511 n.3 (1979) (all wellhead gas, including that dedicated to intrastate market sold after December 1, 1978, is subject to NGPA).

the Texas Supreme Court's own definition of market value illustrates its apparent inapplicability to situations involving federally regulated gas. As defined by the court, "market value" is "the price property would bring when it is offered for sale by one who desires, but is *not obligated to sell,* and is bought by one who is under no necessity of buying it."[266] Certainly the price of gas dedicated to interstate commerce, being subject to federal price ceilings, is not derived as the result of full and free bargaining by the parties. The federal regulatory concepts that gas once sold in interstate commerce is irrevocably dedicated to interstate commerce,[267] and that

266. Exxon Corp. v. Middleton, 613 S.W.2d 240, 246 (Tex. 1981).

267. Under the Natural Gas Act, the FPC required the permanent and irrevocable dedication to interstate commerce of all gas reserves to be served by an interstate gas pipeline as a condition to its issuance of a certificate of public convenience and necessity to the pipeline. The issuance of such a certificate is itself a prerequisite to the construction or operation of an interstate gas pipeline. *See* Nordon-Lawton Oil & Gas Corp. v. Miller, 272 F. Supp. 125, 129 n.12 (W.D. La. 1967) (quoting H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 134-35 (1964)), *aff'd,* 403 F.2d 946 (5th Cir. 1968); 15 U.S.C. § 717f (1938). The apparent logic for this required dedication was that the issuance of the certificate was dependent upon the ability to provide adequate, continuous, and reasonable service, the existence of which criteria, in turn, were dependent upon the presence of an adequate supply of gas. *See* Nordon-Lawton Oil & Gas Corp. v. Miller, 272 F. Supp. 125, 129 n.12 (W.D. La. 1967) (quoting H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, MANUAL OF TERMS 134-35 (1964)), *aff'd,* 403 F.2d 946 (5th Cir. 1968); Wheat, *Administation of the Certificate Provisions of the Natural Gas Act,* 14 GEO. WASH. L. REV. 194, 194-95 (1945); Comment, *Control of Entry into the Natural Gas Pipeline Industry: The FPC and the Certificate of Convenience and Necessity,* 28 IND. L.J. 587, 614-15 (1953). This absolutist concept has been ameliorated somewhat under the NGPA. Under the NGPA, 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. 71-72, *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 9161, 9166. For example, gas which at one time was sold in the intrastate market may be resold in the interstate market and thereby become dedicated to interstate commerce. *Id.* at 9166. Also, gas currently sold in the interstate market may be sold later in the intrastate market. *Id.* at 9166. Further natural gas may lose its status as being dedicated to interstate commerce if the owner of the gas acquired his leasehold interest by a reversion or termination of the leasehold. *Id.* at 9166; Comment, *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,* 11 ST. MARY'S L.J. 502, 524 n.152 (1979). This latter aspect of the NGPA was a direct response to the holding of the United States Supreme Court in *California v. Southland Royalty Co.,* 436 U. S. 519 (1978), wherein the Court held that a lessee which was operating under a lease granting it a 50-year fixed term leasehold when it dedicated the gas reserves underlying the leasehold to interstate commerce, bound the lessor and the reversionary interest holders to such dedication even beyond the expiration of the lease. *See id.* at 525-26. Finally, under the NGPA gas is not considered dedicated to interstate commerce, even if sold in that market, if it was dedicated by one who had no right to explore, develop, produce, or sell such gas on May 31, 1978. Natural Gas Policy Act of 1978, § 2 (18) B(iii) (I), 15 U.S.C. § 3301 (18) (B) (iii) (I) (1978).

a producer is unable to abandon or terminate supplying gas to its purchaser without the approval of the appropriate federal agency,[268] clearly belie the notion that the price of such gas is that received by one under no obligation to sell from one under no compulsion to buy. Indeed, it seems illogical to even attempt to apply the principles of *Vela* and *Middleton* to federally controlled or regulated gas because "there can be no 'market value' or 'market price' in a price-regulated environment."[269] From this, it follows that the royalty payment obligation with respect to regulated gas might appropriately be declared to be satisfied by calculating royalty on the basis of the proceeds received from the sale of the regulated gas, without regard to *Vela* and *Middleton* notions of market value.

Assuming, however, that the concept of market value, as delineated in *Vela* and *Middleton,* is to be applied to sales of regulated and unregulated gas alike, the issue in terms of NGPA-regulated gas becomes how to determine the market value of federally price-controlled gas. None of the gas involved in *Middleton* was subject to the NGPA pricing provisions; consequently, the court in *Middleton* was not required to pass upon the impact of the statute's terms in determining the market value of gas made the object of a *Vela*-type claim. The court, however, did provide some guidance for making such a determination when, in discussing various points to consider in assessing whether gas is of comparable quality, the court stated that "[q]uality also involves the legal characteristics of the gas; that is, whether it is sold in a regulated or unregulated market, or in one particular category of a regulated market."[270] Thus, by implication, the *Middleton* court provided the guiding principle for making a market value determination: volumes of gas which possess differing legal characteristics, such as regulated vis-

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268. Under section 7(b) of the Natural Gas Act, natural gas companies are prohibited from abandoning all or any part of their facilities subject to federal jurisdiction, or any service rendered by means of such facilities, without the permission and approval of the governing federal agency. Such approval is granted only pursuant to notice and hearing and upon a finding that continuance of service is unwarranted due to depletion of reserves or that future public convenience or necessity permits such abandonment. Natural Gas Act, § 7(b), 15 U.S.C. § 717f(b) (1938).

269. Exxon Corp. v. Middleton, 571 S.W.2d 349, 362 n.3 (Tex. Civ. App.—Houston [14th Dist.] 1978), *rev'd*, 613 S.W.2d 240 (Tex. 1981); *accord,* Kingery v. Continental Oil Co., 626 F.2d 1261, 1264 (5th Cir. 1980).

270. Exxon Corp. v. Middleton, 613 S.W.2d 240, 247 (Tex. 1981).

a-vis non-regulated gas, or such as one particular category of a regulated market vis-a-vis another category of a regulated market, are *not* comparable in quality, and sales of one such volume of gas may not be used to ascertain the market value of the other. As applied to NGPA-regulated gas, sales of gas sold subject to the ceiling price limitations of one category of regulated gas are comparable in quality only to other sales of gas classified in that same regulated category; sales of gas from any other NGPA regulated category are not of comparable quality.

The recognition of the non-comparability of volumes of gas subject to different legal classifications and price ceilings suggests that, for purposes of determining the market value of regulated gas, only sales of gas within the same regulatory category as the subject gas need be considered. This seems entirely appropriate. It would be unreasonable to require a producer-lessee, who is free to market its gas in only one NGPA pricing category, because the gas is dedicated by that statute to that particular category, to pay royalty on that gas on the basis of a "market value" derived by reference to sales of gas marketed pursuant to higher price ceilings prescribed by another NGPA category of gas. Furthermore, since the producer-lessee has no means of transferring its gas to a higher prices NGPA category,[271] it would be only fair to require the royalty owner to accept royalties based on the market value of that gas as determined by reference to the prices received for comparable gas sold within that same regulated category. Indeed, a contrary approach would yield patently unfair results. For example, under one NGPA pricing category, the producer of gas being produced and sold prior to November 9, 1978, is entitled to continue to receive the contract price for such gas; thus, the contract price of such gas becomes its NGPA price ceiling.[272] If the "market value" of that gas, for *Vela* claim purposes, is to be determined not by reference to the contract price of other gas sold pursuant to that same NGPA pricing category, but instead by resort to the prices received (or which could have been received) in sales of oth-

271. *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 under another NGPA pricing category once the gas has been sold pursuant to an NGPA pricing category).

272. *See* Natural Gas Policy Act of 1978, § 105, 15 U.S.C. § 3315.

erwise comparable gas subject to another NGPA price category, it is quite possible that the "market value" of that gas would be less than the actual contract price received from its sale.[273] Thus, if the non-comparable quality of gas subject to different NGPA categories is not observed, market value gas royalty litigants could be faced with the anomalous result of having a court find that, for the period in which the gas in question was subject to the NGPA and royalties were paid upon the basis of the proceeds received from the sale of the gas, the producer-lessee overpaid the royalty owners.

Assuming that Texas courts will observe the implications of *Middleton* concerning the variance in quality of gas subject to differing NGPA price categories, there still remains the matter of how to compute the market value of gas subject to regulation under that statute. One alternative would simply involve the application of the generally applicable principles espoused in *Middleton*, restricting the scope of comparable gas sales to those of identically classified regulated gas. This method, however, would be subject to many of the same criticisms discussed in the analysis of the *Middleton* opinion.

Another alternative to the problem of computing the market value of NGPA-regulated gas would equate the "market value" of NGPA-regulated gas to the ceiling price of the applicable NGPA pricing category. This alternative has been suggested by at least

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273. In *Middleton*, for example, Exxon posed the following hypothetical situation.

> Exxon's field price in effect for the Anahuac Field and other fields in Texas Railroad Commission District 3 was $1.80 per Mcf for the last quarter of 1978. As indicated in the record before the Court, some gas is now being delivered under contracts specifying as much as $2.10 per Mcf. Under the provisions of the Natural Gas Policy Act of 1978, the producer of such gas will be entitled to continue to receive the contract price for the volumes of gas delivered under that contract, it having been executed prior to November 9, 1978. However, if the market value of that gas is not to be determined by the amount received for the gas under the contract, but instead should be based on the price which could be received for gas from a new well drilled in the vicinity but not subject to that contract, Section 103 of the Natural Gas Policy Act would prescribe a maximum price for the gas production from such new well for the month of December 1978 of $1.969 per MMbtu. Unless the gas from such new well had an extremely high Btu content, the initial price per Mcf would be less than the price the producer was receiving under his contract for the older gas. If the market value of the gas sold under the contract were not to be determined on the basis of the contract price, but on the basis of the gas from the newly completed well in December 1978, its market value would be less than proceeds of sale.

Exxon Corporation's Pre-argument Brief at 19.

one author[274] and acknowledged by another.[275] This method would first require the producer to ascertain the appropriate NGPA category for its gas, determine the applicable ceiling price for that category of gas as of December 1978, and adjust that ceiling price upward to reflect the applicable monthly inflation factors provided for by the statute.[276] The result of this computation would establish the "market value" of the subject gas in any given month. Certainly this alternative would inject some measure of stability into the currently chaotic process of determining the market value of gas committed for sale under a long-term contract and would clearly constitute a simple, direct method for making what otherwise might be a very complex calculation. Furthermore, there is at least some authority which supports the utilization of this method of market value determination.[277] On the other hand, this method would be an imprecise measure of the market value of regulated gas. This is evident from the fact that the NGPA pricing provisions which would serve as the "market value" of such gas are *ceiling* prices and at least some of the gas subject to these categories is not priced at the maximum levels prescribed by the NGPA.[278] Thus, under this alternative the market value of all gas priced below the NGPA ceiling prices would exceed the price actually received for the gas to a greater extent than would a "market value" ascertained by reference to an averaging process similiar to that used in *Middleton*.[279] This method would, of course, benefit those

274. *See* Comment, *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*, 11 St. Mary's L.J. 502, 525-29 (1979).

275. *See* Hoffman, *Oil and Gas Royalty Problems—Current Issue and Answers*, Sw. Legal Foundation 31st Inst. on Oil & Gas Law & Tax. 211, 228 (1980).

276. *See* Comment, *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*, 11 St. Mary's L. J. 502, 528 (1979).

277. *See* United States v. Commodities Trading Corp., 339 U. S. 121, 124 (1950) (a case arising under World War II price control regulations holding that market value of a certain price-regulated commodity was equal to its ceiling price established by those price regulations); Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 161 (N.D. Tex. 1978) (stating that the FPC rate of gas is its market price), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F. 2d 1261 (5th Cir. 1980).

278. Certain types of gas initially are priced at levels below the applicable ceiling price, while others are, in fact, immediately priced at ceiling levels. *See* Natural Gas Policy Act of 1978, §§ 104-106, 15 U.S.C. §§ 3314-3316 (1978).

279. This follows naturally from the fact that the *Middleton* method of averaging the three highest prices, if utilized in these circumstances, probably would be based upon prices

royalty owners who would have their royalties calculated on the basis of a value higher than the actual proceeds received from the sale of the gas and correspondingly would penalize producer-lessees. Other royalty owners and producer-lessees, however, selling their gas at NGPA price ceilings anyway, would receive neither a windfall nor a penalty from this method of "market value" calculation. However, considering the relative ease with which such a computation could be made, particularly the absence of any need to resort to weight-averaging of gas prices, or expert testimony, or litigation to resolve factual disputes, this alternative might be the proper solution to the problem of determining the market value of NGPA-regulated gas for royalty purposes.

VI. Conclusion

In the aftermath of the Texas Supreme Court's decision in *Texas Oil & Gas Corp. v. Vela*, a multitude of market value gas royalty claims were litigated with conflicting results. The court selected the case of *Exxon Corp. v. Middleton* as a vehicle for harmonizing these conflicting decisions. Although the court's opinion in *Middleton* resolved some conflicts, it raised numerous other issues and, in some respects, failed to adequately analyze issues often raised in market value gas royalty litigation. As a result, this area of Texas law remains as confused and chaotic as it was prior to the *Middleton* decision.

The concept of market value gas royalty determinations now appears to be firmly entrenched in Texas law and its unfortunate results and implications undoubtedly will haunt the petroleum industries for years to come. Indeed, the problems generated by this concept may well become intensified and more complex as these claims begin to focus upon sales of gas made subject to the pricing provisions of the Natural Gas Policy Act of 1978.

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less than the ceiling price (ie. highest price alone) prescribed for the applicable NGPA category of gas.