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Defining the Royalty Obligation

John S. Lowe
Southern Methodist University, Dedman School of Law

DEFINING THE ROYALTY OBLIGATION*

*John S. Lowe***

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I. INTRODUCTION

THE restructuring of the natural gas markets in the 1980s and 1990s has fundamentally changed the way the natural gas industry conducts business. This structural change, in turn, has reignited old

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** George W. Hutchison Professor of Energy Law, Southern Methodist University. Admitted to practice law in Texas, Oklahoma, and Ohio.

disputes between lessors and lessees over which revenues that lessees receive are subject to the royalty obligation.

From its beginnings in the 1930s until the mid-1980s, the United States natural gas industry was linear in structure.[1] Producers extracted natural gas and sold it to pipelines at the wellhead or in the field under long-term contracts that obligated the pipeline to take or pay for minimum quantities of production.[2] Pipelines bought gas from producers and sold it to local distribution companies, state-regulated public utilities that supply gas at the burner-tip, using minimum commodity bill tariffs to shift the risk of their take-or-pay obligations to producers.[3] Local distribution companies retailed gas to end-users.[4]

The linear structure of the gas industry was transformed into a crazy-quilt pattern abruptly in the mid-1980s, however, when a rapid decline in demand for natural gas[5] galvanized the Federal Energy Regulatory Com-

1. My favorite historical treatment is Richard J. Pierce, Jr., *Reconstituting the Natural Gas Industry from Wellhead to Burnertip*, 9 ENERGY L.J. 1 (1988). *See also* Judith M. Matlock, *Overview of Federal Regulation*, *in* OIL AND NATURAL GAS PIPELINES: WELLHEAD TO END USER 2A (1995 ROCKY MTN. MIN. L. FOUND.); Vanessa A. Richelle, Comment, *Reworking Relationships in the Natural Gas Industry: Exploring the New Spot Market and Its Operation*, 68 TUL. L. REV. 655 (1994).

2. A take-or-pay clause, as such provisions are called, typically obligates a purchaser to pay for a percentage of the gas the producer can produce, whether or not the purchaser actually takes it. The provision compensates a seller for long- term dedication of a particular gas supply to a particular purchaser. HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 1099 (9th ed. 1994).

3. Tariff minimum commodity bill provisions required local distribution companies (LDCs) to pay for minimum amounts of gas even when their customers did not use that much gas. 8 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 640 (1995). Minimum bill provisions were designed to compensate pipelines for contracting with producers for reserves to meet the demand of LDCs and their customers.

4. The linear structure of the gas industry resulted from the federal regulatory scheme. The Natural Gas Act of 1938, 15 U.S.C. §§ 717-717z (1994), applied public utility regulation principles to interstate natural gas pipelines, restricting entry to the industry, regulating rates, imposing service obligations, and dedicating facilities. Generally, neither producers, which were regulated by conservation agencies, nor LDCs, which were regulated by state public utility boards, wished to subject themselves to an additional level of federal regulation. In addition, the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79z-6 (1994), imposed an onerous regulatory regime through the Securities Exchange Commission upon vertically integrated gas and electric companies that tended to cause each of the elements of the gas industry to avoid acquiring ownership interests in the others. *See* ARLON R. TUSSING & CONNIE C. BARLOW, THE NATURAL GAS INDUSTRY: EVOLUTION, STRUCTURE, AND ECONOMICS 191-225 (1984); Ralph K. Huitt, *Natural Gas Regulation Under the Holding Company Act*, 19 LAW & CONTEMP. PROBS. 455 (1954).

5. Demand for natural gas in the United States peaked in 1971, when consumption was approximately 22 trillion cubic feet (TCF). By 1979, total consumption had declined to slightly more than 20 TCF. From 1979 to 1983, however, demand dropped a further 15%, from 20 TCF to 17 TCF. The following statistics, summarize the decline:

(Natural Gas Consumption in Trillions of Cubic Feet)

Year	*Residential*	*Commercial*	*Industrial*	*Electric Utilities*	*Other*
1979	5.0	2.8	6.8	3.2	2.2
1983	4.5	2.5	5.5	3.0	1.5

ARTHUR ANDERSEN & CO. & CAMBRIDGE ENERGY RESEARCH ASSOCS., NATURAL GAS TRENDS (1988-89). The precipitous decline was largely due to three factors: conservation, economic structural changes that required less energy, and fuel switching from gas to other mission (FERC) to restructure the industry to promote competition.[6] Within a few years, the gas industry had become a highly competitive set of markets in which pipeline companies are open-access transporters,[7] rather than merchants,[8] and producers may sell in volatile "spot" markets, through brokers or aggregators, or even directly to large consum-

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sources. In addition, the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1994), enacted on the premise that the United States was critically short of natural gas, actually accelerated the decline in natural gas demand by triggering price escalation clauses in gas contracts. Many of the Act's "maximum lawful prices," which were translated into actual prices paid by the gas contracts of the 1970s, exceeded the market price of competing fuels well before deregulation began in 1985.

Gas demand has now recovered to approximately the 1979 levels; natural gas demand totaled approximately 21 TCF in 1994, *Energy Consumption Hits All-Time High with Production at Near-Record Levels*, 23 ENERGY REP. (PASHA) No. 31, at 660 (Aug. 14, 1995) (citing Energy Information Administration, ENERGY REV. 1994), and is expected to grow to 22.5 TCF in 1995. *API Stats on 1994 Cite 1st. Year Imports Exceed 50%*, 23 ENERGY REP. (PASHA) No. 1, at 59-60 (Jan. 23, 1995). The market forces that caused the precipitous decline, however, remain. The conservation movement of the 1970s and 1980s (e.g., reinsulation and storm window installation) continues. The United States continues to move from an industrial economy to a service economy. Fuel switching has become standard industrial practice. Nearly 20% of industrial boilers and process heaters—by far the major component of industrial demand—have residual fuel oil backup, and another 44% could be converted from gas to fuel oil. Marie L. Lihn, *Loss of Industrial Market Share Unlikely Without High Prices*, 10 NAT. GAS, June 1994, at 21, 21.

6. Although the restructuring of the natural gas industry continues, its core is two orders of the Federal Energy Regulatory Commission (FERC). In Order 380, Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, 49 Fed. Reg. 22,778 (1984), FERC permitted LDCs, the regulated public utilities that supply gas at the burner-tip, to avoid variable cost minimum bill provisions in their tariffs with pipelines. Variable cost minimum bills varied with the level of service, with purchased gas the primary component. Minimum bill provisions required LDCs to pay for minimum amounts of gas even when their customers did not use the minimum amounts. In an important sense, minimum bill provisions balanced take-or-pay provisions in contracts between producers and pipelines. Thus, Order 380 left pipelines exposed to huge take-or-pay liabilities to producers, but it also created a demand for short-term sales of natural gas, which were at that time priced well below long-term sales. Order 380 was affirmed by Wisconsin Gas Co. v. FERC, 770 F.2d 1144, 1149 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986).

Having created a demand for short-term gas sales, FERC moved to the supply side of the market. In 1985, FERC issued Order 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 42,408 (1985), which gave firm sales customers of pipelines the right to reduce the amounts they were contractually obligated to purchase and to convert their right to purchase to firm transportation rights. Order 436 also combined carrots and sticks to encourage pipelines to abandon their traditional role of merchant and become open-access transporters of natural gas. Order 436 was a determined attempt to transform interstate pipelines from merchants into transporters. It has been largely successful. Virtually all interstate pipelines are now "open-access." Orders 380 and 436 are responsible for the development of the so-called "spot market," which supplies 70 percent of current U.S. gas demand. Order 436 was affirmed in part and remanded for consideration in part in Associated Gas Distribs. v. FERC, 824 F.2d 981 (D.C. Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988).

7. Open-access transportation is common carriage, for all practical purposes. *See* Paul E. Strohl, *Gas into Gold: The New Alchemy of Financing Oil and Gas Acquisitions in the 1990s*, 39 ROCKY MTN. MIN. L. INST. § 16.01, § 16.02[1], at 16-5 to 16-6 (1994).

8. In 1984, interstate pipeline gas carriage was 8.4% of throughput. By 1987, gas carriage volumes exceeded pipeline sales volumes and comprised 55.6% of throughput. NATURAL GAS TRENDS, *supra* note 5, at 78.

ers.[9] In the old natural gas industry, lessees marketed gas by striking the best deal they could with whatever pipelines had facilities near their wells.[10] In the new natural gas industry, the marketing function has evolved from responding to markets to creating them.[11]

What has been called a "revolution" in the natural gas industry[12] has created a host of legal issues and has focused fresh attention on the royalty obligation. Gas industry restructuring has unbundled and deregulated packages of services that had been uniform and price regulated. As a result, gas producers and royalty owners find themselves locked anew in disputes over which producer-derived revenues are subject to the royalty obligation.[13]

A current issue that has attracted the avid attention of the mineral bar—and to which the bulk of this Article will be devoted—is whether royalty is due on take-or-pay payments,[14] settlements,[15] buy-outs,[16] and buy-downs.[17] Federal energy regulatory policy in the 1960s and 1970s en-

9. *See* WILLIAM D. WATSON, THE GAS SELLER'S COMPANION: A PRACTICAL GUIDE TO GAS CONTRACTS (1992); Robert A. Luettgen, *Drafting Natural Gas Contracts After Order 436: The Producer's Perspective*, 1989 A.B.A. SEC. NAT. RESOURCES, ENERGY, & ENVTL. L. (monograph series No. 11); John S. Lowe, *A New Generation of Gas Contracts*, 8 CORP. COUNS. REV. 1, 6 (1989).

10. Often, there was a single pipeline available. Usually, there were only a few.

11. Jay G. Martin, *Summary of Significant Gas Market and Transportation Changes Affecting Producers in the 1990's*, 37 ROCKY MTN. MIN. L. INST. § 16.01 (1991) (an excellent discussion of the development of the new natural gas marketplace).

12. STEPHEN F. WILLIAMS, THE NATURAL GAS REVOLUTION OF 1985 (1985).

13. Royalty disputes have always been an element of the gas industry. *See, e.g.*, Jacques P. Adoue, *Royalty and Pooling Provisions in Oil, Gas and Mineral Leases*, 2 INST. ON OIL & GAS L. & TAX'N 195 (1951); Robert E. Hardwicke, *Evolution of Casinghead Gas Law*, 8 TEX. L. REV. 1 (1929); Joseph T. Sneed, Comment, *Value of Lessor's Share of Production Where Gas Only is Produced*, 25 TEX. L. REV. 641, 643 (1947).

14. The language of a gas contract take-or-pay clause is often quite simple. The following is excerpted from a gas contract from the Mid-Continent area (Oklahoma/Kansas) entered into in the early 1980s:

> Subject to all the other provisions of this Contract, Seller agrees to sell and deliver and Pipeline agrees to purchase and receive, or pay for if made available hereunder but not taken, a daily contract quantity of gas, averaged over each accounting period (contract quantity) during the term hereof, equal to seventy-five percent (75%) of the maximum quantity of gas that Seller's well/s can deliver to Pipeline. . . .

Take-or-pay clauses usually permit the purchaser to make up gas paid for but not taken, either on a *volumetric basis* (MMBtu for MMBtu paid for) or on a *cash credit basis* (take-or-pay benefits paid are credited against the then-prevailing gas price when make up occurs).

A take-or-pay clause guarantees the producer a minimum cash flow in return for dedicating the gas supply to the purchaser. To economists, take-or-pay clauses provide for a type of "demand charge," a charge for reserving an option to use, rather than a "commodity charge," a charge for the quantity of the commodity used. Producers have historically viewed take-or-pay clauses as a guarantee of a minimum cash flow and protection against the risk that purchasers will "bank" contracted gas in the ground. Pipelines have seen take-or-pay clauses as a non-price premium for gas commitment.

15. A take-or-pay settlement compromises a take-or-pay claim, usually for less than its face amount, without changing the contract provisions.

16. A buy-out payment extinguishes a purchaser's obligation to take volumes in the future under a contract being reformed or terminated.

17. A buy-down payment reduces the price of future production to the original purchaser under an amended or successor contract.

couraged consumption of natural gas by setting artificially low prices at the wellhead, thereby discouraging exploration and development and leading inevitably to supply shortages.[18] The Natural Gas Act of 1938 and the Natural Gas Policy Act of 1978 effectively barred price competition. Therefore, some pipelines competed to meet what they perceived to be huge long-term supply shortages by offering high take-or-pay percentages to producers, who gladly accepted the offers as risk-shifting devices that would protect them against demand fluctuations. Take-or-pay percentages increased from as low as twenty-five percent in the early 1970s to as much as ninety percent at the height of the gas boom.[19]

When gas demand in the United States declined sharply in the early 1980s, the gas boom became a litigation boom as gas pipelines defaulted on their take-or-pay obligations and asserted a variety of affirmative defenses.[20] The take-or-pay problem was exacerbated in the mid-1980s by FERC's industry restructuring, which sharply contracted pipeline sales[21] and created stiff competition in the pipelines' traditionally monopoly markets. Many pipelines were confronted with take-or-pay liabilities that were often larger than their net worths. The total potential liability of pipelines was probably in the range of sixty to seventy billion dollars,[22] and settlement costs were probably in the range of twelve to fifteen billion dollars.[23]

Royalty owners now claim that the royalty obligation attaches to the settlements collected by producers. The take-or-pay royalty issue is just one example,[24] however, of the broader problem of defining the revenues

18. *See* Richard J. Pierce, Jr., *The Evolution of Natural Gas Regulatory Policy*, 10 NAT. RESOURCES & ENV'T 53, 54 (1995).

19. John S. Lowe, *The Take-or-Pay Wars—Is Peace at Hand?*, 8 OIL & GAS L. & TAX'N REV. 3, 3 (1990).

20. The "take-or-pay wars" are chronicled in J. Michael Medina, *A Report from the Battle Zone: The Take Or Pay Wars*, 58 OKLA. B.J. 2554 (1987), and J. Michael Medina, *The Take-Or-Pay Wars: A Further Status Report*, 41 OKLA. L. REV. 381 (1988).

21. From 1984 to 1987, sales by interstate pipeline companies of natural gas declined from approximately 11.75 TCF to 5.6 TCF, though total use of natural gas in the United States declined only from approximately 17.9 TCF to 16.7 TCF. NATURAL GAS TRENDS, *supra* note 5, at 38, 84-85. The sharp decline in sales by pipelines matched declines in gas dedicated as a result of contracts terminated after renegotiation of take-or-pay disputes.

22. The costs of settlement were largely passed on to consumers. *See* John S. Lowe, *The Take-or-Pay Wars — Is Peace at Hand?*, 8 OIL & GAS L. & TAX'N REV. 3, 3 (1990).

23. In mid-1989, interstate pipelines reported paying producers $8.8 billion in take-or-pay settlements over the years. FACT SHEET ON TAKE-OR-PAY IN 1988: AN INTERIM REPORT (1989). That same year, FERC summarized reports that it had received from pipelines subject to its jurisdiction noting settlement costs through March 31, 1989 of $8.2 billion paid for past and future contract liability claims valued at $44 billion. Order 500-H, 54 Fed. Reg. 52,344, 52,356 (1989).

24. The problem of royalty on take-or-pay benefits has been well explored, nonetheless. *See, e.g.*, Si M. Bondurant, *Royalty Owner Rights Under Division Orders*, 25 TULSA L.J. 571 (1990); Cyril A. Fox, Jr., *Rights of a Lessor in Payments Received by a Producer from "Buydowns" or "Buyouts" of Long-Term Contracts*, 10 E. MIN. L. INST. 1-1, § 1.02 (1989); James C.T. Hardwick & J. Kevin Hayes, *Gas Royalty Issues Arising from Direct Gas Marketing*, 43 INST. ON OIL & GAS L. & TAX'N 11-1, § 11.05 (1992); Bruce M. Kramer, *Royalty Obligations Under the Gun — The Effect of Take-or-Pay Clauses on the Duty to Make Royalty Payments*, 39 INST. ON OIL & GAS L. & TAX'N 5-1, § 5.05[2] (1988); F. Henri Lapeyre, Jr., *The Rights of Royalty Owners to Share in Take-Or-Pay Payments or Settle-*

subject to the royalty obligation after industry restructuring.[25] Other issues include whether royalty is due on incentive payments to the lessee, (e.g., gas inventory charges,[26] reservation fees,[27] and supply bonuses[28]) upon production payments to the lessee,[29] or upon profits from investment devices such as hedges, trades, or swaps.[30]

The thesis of this Article is that the current controversy over whether royalty is due on take-or-pay benefits is closely related to litigation of a generation ago about the meaning of "market value." The principles developed in the market value litigation are likely to be applied to resolve current royalty disputes, such as the issue of royalty on take-or-pay benefits. The Article first examines the background of the royalty on take-or-pay disputes, including the interpretative principles applied by the courts in market value royalty cases. The Article traces the controversy over royalty on take-or-pay benefits, analyzing the cases and their theories in an attempt to rationalize the developing lines of precedent. After determining that the lines of cases are irreconcilable, it predicts the likely di-

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ments, 38 ROCKY MTN. MIN. L. INST. 18-1 (1992); John S. Lowe, *Current Lease and Royalty Problems in the Gas Industry*, 23 TULSA L.J. 547 (1988); Richard C. Maxwell, *Oil and Gas Royalties — A Percentage of What?*, 34 ROCKY MTN. MIN. L. INST. 15-1 (1988); David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 E. MIN. L. INST. 18-1, § 18.03 (1992); Richard J. Pierce, Jr., *Lessor/Lessee Relations in a Turbulent Gas Market*, 38 INST. ON OIL & GAS L. & TAX'N 8-1, § 8.03 (1987); Ernest E. Smith, *Royalty Issues: Take-or-Pay Claims and Division Orders*, 24 TULSA L.J. 509 (1989); William H. White, *The Right to Recover Royalties on Natural Gas Take-or-Pay Settlements*, 41 OKLA. L. REV. 663 (1988); Arthur J. Wright & Carla J. Sharpe, *Direct Gas Sales: Royalty Problems for the Producer*, 46 OKLA. L. REV. 235 (1993); T.N. Leach, Note, *Recent Development* - Frey v. Amoco Production Co.: *Payment of Mineral Royalties on Take-Or-Pay Settlements in Louisiana*, 67 TULSA L. REV. 840 (1993).

25. One commentator has suggested that an index-based royalty would solve the problems caused by restructuring. David E. Pierce, *Incorporating a Century of Oil and Gas Jurisprudence Into the "Modern" Oil and Gas Lease*, 33 WASHBURN L.J. 786, 815-33 (1994). Another has suggested that the royalty should be based on the price received by the lessee while specifically providing for sales to affiliates and deduction of certain costs. Thomas W. Lynch, *The "Perfect" Oil and Gas Lease (An Oxymoron)*, 40 ROCKY MTN. MIN. L. INST. 3-1, § 3.06 (1994).

26. A gas inventory charge (GIC) is collected by a supplier " 'for standing ready to supply gas to sales customers.' " American Gas Ass'n v. FERC, 888 F.2d 136, 144 (D.C. Cir. 1989) (quoting Order No. 500, 52 Fed. Reg. 30,334, 30,346 (1987)). A GIC, like a take-or-pay provision, is a demand charge. *See* Sheila S. Hollis, *The Changing Framework of Natural Gas Business and Law*, 35 ROCKY MTN. MIN. L. INST. 14-1, § 14.02, at 14-27 (1989).

27. A reservation fee is a demand charge collected for guaranteed or "firm" service. WILLIAMS & MEYERS, *supra* note 2, at 939.

28. A supply bonus is paid only if certain non-contractually-binding standards are met; e.g., a gas purchaser may agree to pay a bonus to a producer who supplies more than a stated amount over a stated period of time.

29. Enron Corporation has been particularly active in structuring production payment transactions. Enron may lend money to a company to purchase or develop gas reserves. Production from the field is then used to repay the loan. Alan Kovski, *Enron Corp. Discovers New Way to Finance Independent Producers*, OIL DAILY, Jan. 28, 1994, at 1. For discussion of the device, see Strohl, *supra* note 7, § 16.01.

30. For discussion of the modern generation of investment devices, see Mark E. Haedicke, *Contracts for the New Natural Gas Business*, 13 ENERGY L.J. 313 (1992); Kathleen R. McLaurin, *Trends in Natural Gas Contracts: Hedges, Swaps and Forward Sales, in* U. OF TEX. SCH. OF L., 19TH ANN. OIL, GAS & MIN. L. INST. § 5 (1993).

rection of future case law and suggests limits to the logic of the case law. The Article concludes by considering the implications of the royalty on take-or-pay benefits cases for other disputes about the extent of the royalty obligation.

This Article examines only whether the royalty clause of the typical oil and gas lease includes take-or-pay benefits and some other benefits provided by the deregulated gas markets. This analysis does not examine the related, but conceptually distinct, issues of what deductions may be made in calculating royalty and the scope of the implied covenants to market or to operate diligently and properly.[31]

II. FUNDAMENTAL INTERPRETATIVE PRINCIPLES

Typical lease royalty clauses are simply too general to help define the royalty obligation. Lease royalty clauses usually contain separate and essentially different provisions for oil and for gas.[32] Oil royalty clause provisions commonly provide for royalty in kind and present relatively few interpretative difficulties; royalty is "to be delivered at the wells or to the

31. In addition to the issue of which revenues are subject to royalty, gas industry restructuring has raised questions about what expenses the royalty must share. For example, it is unclear whether the royalty must share all of the unbundled transportation costs a producer may elect to utilize, including pipeline disciplinary charges such as gas imbalance penalties incurred by the producer. Other examples of the uncertainty over expense-sharing include whether various taxes are deductible proportionately from royalty and whether the marketing expenses that lessees have traditionally borne but that are substantially higher in the deregulated market may be passed through to royalty owners. The expense-sharing issue, while related and parallel to the issue of which revenues are subject to the royalty obligation, has been excluded from this discussion in an effort to keep this Article reasonable in length.

32. The different royalty provisions for oil and gas stem from the physical and economic differences between the two substances. The royalty share of oil can be temporarily stored at or near the well and sold by the truckload. Natural gas, however, cannot be stored economically and must be delivered into a pipeline. In addition, larger volumes of gas usually command a premium; royalty in cash rather than in kind benefits both lessee and lessor. JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 272 (3d ed. 1995).

The distinction between royalty in kind and royalty in cash may or may not be significant. Where royalty is in kind, courts hold that the lessor retains legal title to the production as personal property: "[t]he covenant with respect to delivery of the royalty oil has to do with . . . oil which the lessor already owns." 3 EUGENE KUNTZ, OIL AND GAS § 39.2(b) (1989). Where royalty is paid in cash, the lessee acquires title to production as it comes from the ground. Greenshields v. Warren Petroleum Corp., 248 F.2d 61, 67 (10th Cir.), *cert. denied*, 355 U.S. 907 (1957). Title to production is a significant factor in determining whether the lessee can dispose of the royalty share without the lessor's approval and in establishing the remedy available to royalty for nonpayment. Conversion may be available to a lessor whose in-kind royalty right is ignored, while an action to recover an unsecured debt is appropriate where cash royalty is not paid. HOWARD R. WILLIAMS, OIL AND GAS LAW § 659.1 (1993). Some courts have held that the form of royalty affects application of tax statutes. Homestake Exploration Corp. v. Schoregge, 264 P. 388 (Mont. 1928) (stating that lessor is not subject to net proceeds tax where royalty is payable in cash). Others, however, have rejected such a distinction. Sheffield v. Hogg, 77 S.W.2d 1021, 1024 (Tex. 1934) (holding that both royalty in kind and royalty in cash are taxable as real estate because a stable oil industry requires that oil interests be treated as real estate).

credit of Lessor into the pipe line to which the wells may be connected."[33] Gas royalty provisions usually provide for cash payments of royalty based upon "market value at the well," "market price at the well,"[34] or "amount realized at the well."[35] Gas royalty provisions, in particular, have always prodigiously generated litigation because the royalty is generally due in cash rather than in kind and because the sale that generates the cash often occurs downstream from the well.[36]

Black letter law states that the courts solve interpretative disputes in oil and gas leases or conveyances, as in conveyances and contracts generally, by applying hoary rules of judicial construction:

> First, the court will attempt to ascertain intent by examining the language . . . in dispute.
>
> . . . .
>
> When an instrument's substance is determined to be clear or unambiguous, the parties' intent must be effectuated.
>
> In cases in which an instrument is not so clear (*e.g.*, different provisions of the instrument seem inconsistent or contradictory), the court will, if possible, harmonize the provisions in accord with the parties' apparent intent. . . . If examination solely of the language within the instrument's four corners does not yield a clear understanding of the parties' intent, the court will generally proceed to . . . discretionary implementation of applicable "canons" of contract construction. . . .
>
> Application of "canons" of construction may provide a court with an objective inference of the parties' intent. But if, at this step in the process, intent remains unascertainable (*i.e.*, the instrument is still considered ambiguous), then the court may resort to a final tier in the three-tiered process of construction. This final tier entails consideration of extrinsic or parol evidence.[37]

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33. EUGENE O. KUNTZ ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 11 (2d ed. 1993) (AAPL Form 675, Oil and Gas Lease, Texas Form, Form # 3).

34.
> Market price is the price that is actually paid by buyers for the same commodity in the same market. It is not necessarily the same as "market value" or "fair market value" or "reasonable worth." Price can only be proved by actual transactions. Value or worth, which is often resorted to when there is no market price provable, may be a matter of opinion.

Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409, 410-11 (5th Cir. 1944). *But see* Arkansas Natural Gas Co. v. Sartor, 78 F.2d 924 (5th Cir.), *cert. denied*, 296 U.S. 656 (1935) (where royalty is due on value calculated at the market price, value and price are interchangeable and refer to the average price in the field).

35. This is not an exhaustive list of the many variations of royalty formulations.

36.
> A key to understanding royalty disputes is to note that the lessor's royalty is due at the well (where the product of development is captured) while oil and gas — particularly gas — are often sold "downstream" from the well. Where royalty is due to the lessor in kind, as is generally the case with oil royalty, or where there is an arm's length sale at the well, there are few disputes. Where royalty must be calculated, based upon a hypothetical "market value" or upon a downstream sale price, however, disputes between lessors and lessees are almost inevitable.

JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 272 (3d ed. 1995).

37. Pursue Energy Corp. v. Perkins, 558 So. 2d 349, 352–53 (Miss. 1990) (citations omitted).

The first step in the interpretative process is frequently referred to as the "four corners rule," because the courts look to the four corners of the instrument to ascertain the parties' intent.[38] But because certainty is a bedrock principle, particularly in matters relating to real property ownership, the courts seek objective evidence of intent in the terms of the instrument.[39]

If the four corners review yields no clear intent, the courts turn to rules of construction. The canons of construction commonly used in the second tier of the interpretative process[40] include the doctrines that the instrument be construed against the drafting party,[41] that handwritten or typed language prevails over inconsistent printed language,[42] that the granting clause prevails if there is an irreconcilable conflict among clauses,[43] and that a specific description prevails over a general description.[44] There are many other such canons.[45]

As a last resort, courts often examine extrinsic evidence of the circumstances surrounding the conveyance. They may consider parol (oral) evi-

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38. "[W]hile the inquiry may not stop with the lease language, it nevertheless most certainly must start" there. Klein v. Jones, No. 90-2060 (W.D. Ark. filed Jan. 5, 1994). "[T]he written instrument is presumed to embody their entire contract, and the court should not read into the instrument additional provisions unless this be necessary in order to effectuate the intention of the parties as disclosed by the contract as a whole." Danciger Oil & Ref. Co. v. Powell, 137 Tex. 484, 490, 154 S.W.2d 632, 635 (1941). The four corners rule is itself a canon of construction. *See* Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH. L. REV. 1, 65-72 (1993).

39. The interpretative process for contracts is very much the same as for conveyances, although somewhat less rigid. LAURENCE P. SIMPSON, HANDBOOK OF THE LAW OF CONTRACTS § 210 (2d ed. 1965). *See* Cambridge Oil Co. v. Huggins, 765 S.W.2d 540 (Tex. App.—Corpus Christi 1989, writ denied).

40. At this stage, the courts are no longer truly looking for the parties' intent. As Professor Bruce Kramer points out:

> "Canons of construction are merely statements of judicial preference for the resolution of a particular problem. They are based on common human experience and are designed to achieve what the court believes to be the 'normal' result for the problem under consideration. Thus, their purpose is not to ascertain the intent of the parties to the transaction. Rather, it is to resolve a dispute when it is otherwise impossible to ascertain the parties' intent."
> When understood not to be a substitute for rational thought and common sense, canons of construction are very useful and provide a degree of certainty to the conveyancing industry. However, when abused, the battle of "canons" replaces rational thought and common sense and leads to obfuscation and uncertainty.

Kramer, *supra* note 38, at 4-5 (quoting 6A RICHARD R. POWELL, THE LAW OF REAL PROPERTY § 899[3], at 81A-108 (Patrick J. Rohan ed., 1992)).

41. With oil and gas leases, this rule normally results in a construction against the lessee. In fact, the premise that the lease is *always* to be interpreted contrary to the lessee's interests is sometimes asserted. *See, e.g.*, Klein v. Jones, 980 F.2d 521, 531 (8th Cir. 1992) (discussed *infra* in the text accompanying notes 127 to 134). For discussion of the canon, see Kramer, *supra* note 38, at 103-17.

42. *See* Kramer, *supra* note 38, at 96-100.

43. Alford v. Krum, 671 S.W.2d 870 (Tex. 1984), *overruled by* Luckel v. White, 819 S.W.2d 459 (Tex. 1991). These cases are discussed in Kramer, *supra* note 38, at 57-58.

44. Kramer, *supra* note 38, at 90-95.

45. See *id.* for an excellent discussion of other canons used in construing mineral conveyances.

dence, the performance of the parties before the dispute, and letters, memoranda, or records bearing upon the negotiations that led to the ambiguous deed or lease.[46]

In addition, while the technique is not an accepted part of the general interpretative process, a court may look beyond the words of oil and gas leases to implied covenants. A court may consider promises implicit in the factual circumstances of the lease or arising from the parties' legal relationship, particularly if the court concludes the parties did not contemplate the situation that is the source of the dispute.[47]

III. THE FAILURE OF PRINCIPLE

The three-tiered judicial construction of disputed language is not certain to lead to the parties' intent. The four corners rule often leads to literal interpretations in which the result turns on the choice of a word or phrase or the placement of a comma. The canons of construction are often contradictory, so that choosing the applicable canon for the second tier determines the outcome. The sheer number of rules of construction and the lack of agreement as to which should be applied, and when, virtually guarantee confusion. Some canons of construction further policy goals unrelated to intent. For example, the rule that an instrument will be construed against the drafting party promotes certainty in title and care in drafting but does not guide us to intent. Finally, extrinsic evidence is likely to be either self-serving or inconclusive. At best, the three-step process of judicial construction provides an objective, reasonable inference of the parties' intent. At worst, the process results in a fictional intent unrelated to the reality of the transaction.

Litigation over the oil and gas lease royalty obligation shows the judicial construction process at its worst. In the context of royalty litigation, different courts have applied the same fundamental principles of judicial construction differently and have reached disparate and confusing results.[48] It appears the best we can hope for is that the various jurisdictions will deal with the issue of royalty on take-or-pay benefits and other benefits of the restructured market consistently with their treatment of the "market value" royalty problem.

A. The Market Value Cases

The market value royalty disputes are a good example of the failure of the fundamental interpretative principles to lead to the parties' intent. The courts have split on the meaning of "market value" or "market

46. Roger A. Cunningham et al., The Law of Property 717 (1984).

47. Frey v. Amoco Prod. Co., 603 So. 2d 166, 172 (La. 1992) ("To these basic concepts [of lease interpretation], we add one other. In Louisiana, a mineral lease is interpreted so as to give effect to the covenants implied in every such lease." (citation omitted)).

48. I have made a similar argument that the three-tiered judicial interpretation process has confused the meaning of the term "minerals" in deeds. John S. Lowe, *What Substances are Minerals?*, 30 Rocky Mtn. Min. L. Inst. 2-1, § 2.01 (1984); John S. Lowe, *Developments in Non-Regulatory Oil and Gas Law*, 32 Inst. on Oil & Gas L. & Tax'n 117 (1981).

price" in the lease royalty clause when the lessee sells natural gas at a dedicated long-term contract price different from the current market price, a common occurrence during the 1970s and 1980s, when a combination of market forces and government regulation caused new gas contract prices to escalate faster than regulated long-term contract price adjustments. The same issue was decided differently by courts applying the same analytical process.

A majority of courts, interpreting the laws of Texas,[49] Kansas,[50] Montana,[51] North Dakota,[52] Mississippi,[53] and West Virginia,[54] ruled that "market value" is the current market value when the gas is produced and delivered, even though the gas is dedicated to a long-term contract at a lower price. A minority of jurisdictions, including Oklahoma,[55] Louisiana,[56] and Arkansas,[57] held that "market value" is the dedicated contract price, as long as the lessee entered into the contract prudently and in good faith.[58]

The essential difference between the two lines of market value royalty cases is their application of the fundamental interpretative principles. The majority view is that "market value" is a "plain term" that must be given its usual meaning—the price a willing buyer and seller would agree upon at the time of production.[59] Interpreting a royalty clause that called for royalty based upon the "market price at the wells," the court in *Texas Oil & Gas Corp. v. Vela*[60] made the classic statement of the analysis:

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49. Exxon Corp. v. Middleton, 613 S.W.2d 240, 244-45 (Tex. 1981).

50. Lightcap v. Mobil Oil Corp., 562 P.2d 1, 11 (Kan.), *cert. denied*, 434 U.S. 876 (1977).

51. Montana Power Co. v. Kravik, 586 P.2d 298, 302 (Mont. 1978).

52. West v. Alpar Resources, Inc., 298 N.W.2d 484, 487 (N.D. 1980).

53. Piney Woods Country Life Sch. v. Shell Oil Co., 726 F.2d 225, 236 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985).

54. Imperial Colliery Co. v. OXY USA, Inc., 912 F.2d 696, 700 (4th Cir. 1990).

55. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269, 1273 (Okla. 1981).

56. Henry v. Ballard & Cordell Corp., 418 So. 2d 1334, 1339 (La. 1982).

57. Hillard v. Stephens, 637 S.W.2d 581, 583 (Ark. 1982).

58. Either approach has little or nothing to do with the original purpose of the royalty clause. The drafters intended to make clear that when gas is not sold at the well, either because there is no market for gas at the well or because there is a better market elsewhere, the lessee will have the right to deduct the lessor's proportionate share of additional costs involved to "work back" to the value of the gas at the wellhead. John S. Lowe, *Developments in Non-Regulatory Oil and Gas Law*, 32 INST. ON OIL & GAS L. & TAX'N 117, 144-52 (1981).

59. Not surprisingly, not all of the market value royalty decisions fit neatly into this analysis. In J.M. Huber Corp. v. Denman, 367 F.2d 104 (5th Cir. 1966), the course of the parties' conduct, including a rejected contract draft with contrasting terms and statements of counsel before the Federal Power Commission, provided ample justification "that the literal terms . . . should be given their literal meaning." *Id.* at 109. In *Lightcap*, 562 P.2d at 9, the court treated "market value" as ambiguous and applied "the well recognized doctrine that ambiguous instruments are to be construed strictly against their draftsmen." *Id.* (citations omitted). More recently, the Fifth Circuit considered the function of the clause in holding that Mississippi would adopt the market value rule: "Resort to grammatical parsing is less instructive here than is a consideration of the purpose of the gas royalty clause, taken as a whole." *Piney Woods*, 726 F.2d at 230.

60. 429 S.W.2d. 866 (Tex. 1968).

> [The parties to the lease] might have agreed that the royalty on gas produced from a gas well would be a fractional part of the amount realized by the lessee from its sale. Instead of doing so, however, they stipulated in *plain terms* that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. This clearly means the prevailing market price at the time of the sale or use.[61]

By this view, rules of construction or extrinsic evidence of special meaning are unnecessary.[62]

The minority view is that "market value" is either ambiguous or is a term of art in the gas industry. Courts must therefore look beyond the four corners of the lease to the parties' intent, to implied covenants, or to fundamental fairness. Cases following this approach have concluded that the "market value" of gas is the long-term contract price, even though that price may be less than the current market price in a fair, arms-length contract. The leading case in this line of reasoning is *Tara Petroleum Corp. v. Hughey*.[63] In *Tara*, the Oklahoma Supreme Court considered a lease that provided for royalties based upon "market price at the well"[64] and determined:

> [c]onceding that competent parties should be held to their agreements even though improvident, the typical [royalty] clause . . . seems to be freighted with inherent ambiguity when it is remembered that gas must be sold by long term contracts in which buyers have been able to obtain schedules of prices almost certain to get out of line with contemporary contracts . . . .[65]

The court relied upon the "well-known reality of the business"[66] that the lessee has an implied covenant to market, the fundamental unfairness to producers of royalties based on a price higher than the contract price, and "the intent and understanding"[67] of the parties to the lease. The court concluded that " 'the ambiguity should be resolved in favor of the lessee as a matter of law, with inquiry restricted to whether the sale was a reasonable contract when made.' "[68]

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61. *Id.* at 871 (emphasis added).

62. Most of the cases adopting the market value royalty rule used similar language to describe their analysis. In Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964), the court treated as fixed and unambiguous a royalty provision calling for royalties based on the "market price . . . prevailing." In addressing a clause calling for "market value at the well" royalties, the Texas Supreme Court used exactly the same language as that quoted from *Vela* in the text accompanying note 61, *supra*. Exxon Corp. v. Middleton, 613 S.W.2d 240, 245 (Tex. 1981). The language from *Vela* was in turn quoted favorably in Holmes v. Kewanee Oil Co., 664 P.2d 1335, 1339 (Kan. 1983), *cert. denied*, 474 U.S. 953 (1985), in which the court applied the market value royalty rule. *See also Imperial Colliery Co.*, 912 F.2d at 700 (declining to find that a division order changed the effect of a clear and unambiguous market value clause).

63. 630 P.2d 1269 (Okla. 1981).

64. *Id.* at 1272.

65. *Id.* at 1273 (quoting 3A. W.L. SUMMERS, OIL AND GAS § 589 (2d. ed. William J. Flittie Supp. 1980) at 22-23).

66. *Id.* at 1274.

67. *Id.*

68. *Tara*, 630 P.2d at 1274 (quoting SUMMERS, *supra* note 65, at 22-23).

In *Hillard v. Stephens*,[69] the Arkansas Supreme Court largely followed the *Tara* reasoning. The court quoted extensively from the *Tara* court's consideration of the "necessity of the market" that the lessee market within a reasonable time at the best price available.[70] The court concluded that the long-term contract price was the "prevailing market price at the well"[71] because that result was "consistent with the intent and the understanding of both"[72] lessor and lessee and "is the only interpretation that operates fairly for the producer."[73]

A Louisiana case, *Henry v. Ballard & Cordell Corp.*,[74] also treated "market value" as ambiguous and concluded that the producer's long-term contract price established "market value."[75] The Louisiana Supreme Court rejected *Vela* and similar "plain terms" cases because they gave "[t]he practical and economic necessities of the oil and gas industry at the time the leases were negotiated . . . little or no consideration."[76] Noting that "[t]he ambiguity in the language of the royalty provisions arises from the failure of the parties to the lease to expressly state whether 'market value' means *current* market value,"[77] the court reasoned that the royalty clause ambiguity must be resolved by considering the "necessary realities of the oil and gas industry"[78] and the "custom of the industry."[79] Among the factors that the Louisiana court contended should be considered in resolving the ambiguity was the nature of the oil and gas lease as a "cooperative venture"[80] between lessor and lessee in which "the lessor contributes the land and the lessee the capital and expertise necessary to develop the minerals for the mutual benefit of both parties"[81] so that the parties " 'usually contemplate that the lessee will dispose of the gas (in a prudent manner) and pay the lessor the fractional part of the value which he is to enjoy from the enterprise.' "[82]

The cooperative venture principle stated in *Henry* was an important, if unstated, premise for *Tara v. Hughey* and *Hillard v. Stephens*. Both cases were predicated upon an implied covenant to market, which imposed upon the lessee the "necessity" of contracting at the market price available.[83] According to the Louisiana Supreme Court, the cooperative na-

69. 637 S.W.2d 581 (Ark. 1982).
70. *Id.* at 584 (quoting *Tara*, 630 P.2d at 1273).
71. *Id.* at 583.
72. *Id.* at 585.
73. *Id.*
74. 418 So. 2d 1334 (La. 1982).
75. *Id.* at 1341.
76. *Id.* at 1338.
77. *Id.* at 1337.
78. *Id.* at 1339.
79. *Henry*, 418 So. 2d at 1340.
80. *Id.* at 1338.
81. *Id.* (citing Thomas A. Harrell, *Developments in Non-Regulatory Oil & Gas Law*, 30 INST. ON OIL & GAS L. & TAX'N 311, 334 (1979)).
82. *Id.* (quoting Harrell, *supra* note 81, at 335).
83. *Tara*, 630 P.2d at 1273; *Hillard*, 637 S.W.2d at 584.

ture of the lease gives rise to the implied covenant to market.[84] Viewing the lease as a cooperative venture supports the inference that the lessor and lessee intended that "market value" or "market price" would be based upon the long-term contract price where the lessee prudently entered into a long-term contract.[85] Thus, the cooperative venture rule may be seen either as a harmonizing principle used in interpreting the four corners of the lease, or as a specialized canon of construction that American courts have used to interpret ambiguous royalty clauses.

B. THE ROYALTY ON TAKE-OR-PAY CASES

The cases involving claims for royalty on take-or-pay benefits proceed on the same premises as the market value cases from their jurisdictions. They seem destined to leave the law and the industry even more split.

The two lines of cases begin with different premises that mirror those applied in the market value cases. The premise of the cases holding that "production" is the prerequisite for royalty so that royalty cannot be due on a payment in lieu of production is that the lease is a closely negotiated business transaction designed to apportion risk between the lessee and the lessor. Therefore, the lease royalty clause expresses the "plain meaning" of the parties and "production" or "sale" should be interpreted strictly, just as was "market value." The theory of the countervailing line of cases—fast becoming known as the "cooperative venture" theory[86]—is that the lease royalty clause is not a closely bargained for provision that defines the precise limits of the royalty obligation, but a statement of the general expectations of both parties. A lessor, who owns mineral rights but lacks the expertise and/or money to develop them, transfers the rights

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84. " 'From [the cooperative nature of the lease] arises the affirmative, although implied obligation of the lessee to market....' " *Henry*, 418 So. 2d at 1338 (quoting Harrell, *supra* note 81, at 334).

85. We have recognized this necessity of the market, and we believe that lessors and lessees know and consider it when they negotiate oil and gas leases....

> ... We do not believe that the lessors ... ever contemplated that the lessors' royalty could be [disproportionate to the royalty percentage of the amount realized].

Tara, 630 P.2d at 1273 (quoted in *Hillard*, 37 S.W.2d at 584).

86. The precise terminology is not crucial to the analysis. For example, the cooperative venture analysis is not substantially different from treating the oil and gas lease as a relational contract, an agreement in which the parties are incapable of reducing important terms of the agreement to well-defined obligations, perhaps because the problems that the contract should address cannot be predicted accurately or because the parties are unable to agree upon solutions to problems that may arise. Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1092 (1981). Instead of attempting to define the parameters of their agreement in a discrete contract, the parties to a relational contract agree to establish a relationship, with the explicit or implicit understanding that the parties will use good faith to sort out unanticipated problems. Distributorships, franchises and employment contracts are the classic examples of relational contracts, but oil and gas leases have been described as relational contracts, as well. Charles J. Meyers & Steven M. Crafton, *The Covenant of Further Exploration — Thirty Years Later*, 32 ROCKY MTN. MIN. L. INST. 1-1, § 1.04 at 1-19 (1986). *See also* MAURICE H. MERRILL, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES § 220 (2d ed. 1940).

to a lessee, who either possesses or implies that it can acquire what the lessor lacks. If the lessee develops the mineral rights successfully, the lessor expects to share proportionately in the benefits of the development.

Diamond Shamrock Exploration Co. v. Hodel[87] is perhaps the most cited case denying royalty on take-or-pay benefits. Interpreting a federal off-shore lease calling for royalties of "16⅔% in amount or value of production saved, removed, or sold from the leased area,"[88] the Fifth Circuit Court of Appeals denied the federal government a royalty share of take-or-pay payments made under a gas contract because the government's claim did not:

> comport with the plain meanings of the words in the lease, and in the relevant statutes and regulations. . . . [R]oyalties are not due on "value" or even "market value" in the abstract, but only on the value of *production saved, removed or sold* from the leased property. . . . Consequently, royalties are not owed unless and until actual production, the severance of minerals from the formation, occurs.[89]

The court reasoned that royalty is a payment for production, while take-or-pay payments are paid in lieu of production.[90] Take-or-pay payments are not for the gas sold, said the court, but rather for the failure to purchase gas.[91] The lessor does not "shoulder the . . . risks of exploration, production and development;" and so should not share in the take-or-pay benefits.[92] Because the lease required royalty payments only on the value of minerals actually produced, the court held that no royalty was due on take-or-pay payments until the make-up gas was produced and the payment recouped.[93] Under such a lease, if the purchaser never makes up the volumes paid for, "there is nothing to value either by market or otherwise."[94]

Texas courts have followed similar reasoning. In *Killam Oil Co. v. Bruni*,[95] the lessor sought royalties on a take-or-pay settlement under a lease drafted by the lessor that provided for "market value at the well" royalties on "gas . . . *produced* from said land and *sold or used off the premises*."[96] The Texas Court of Appeals in San Antonio denied recovery because "the term 'production' . . . means the actual physical extraction of the mineral from the soil."[97] The court noted that the lessor, a

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87. 853 F.2d 1159 (5th Cir. 1988).
88. *Id.* at 1161. The lease language tracks the provisions of 30 C.F.R. §§ 206.150 & 206.151 (1995).
89. *Diamond Shamrock*, 853 F.2d at 1165 (emphasis in original).
90. *Id.*
91. *Id.* at 1167.
92. *Id.*
93. *Id.* at 1168. Thus, the court distinguished between *recoupable* take-or-pay payments—those which entitle the gas purchaser to take gas at a later date—and *non-recoupable* payments—those which do not entitle the purchaser to take gas later.
94. *Diamond Shamrock*, 853 F.2d at 1167.
95. 806 S.W.2d 264 (Tex. App.—San Antonio 1991, writ denied).
96. *Id.* at 266 (emphasis in original).
97. *Id.* at 267.

trust, could have provided specifically for royalties on take-or-pay settlements,[98] but reasoned that by choosing the language of the royalty clause "the Trust unambiguously limited its right to royalty payments only from gas actually extracted from the land."[99] The court concluded by holding that:

> under a standard lease, take-or-pay payments do not constitute any part of the price paid for produced gas, nor do they have the effect of increasing the price paid for gas that was taken. These payments are made when gas is *not produced*, and as such, bear no royalty.[100]

The same Texas court reaffirmed its reasoning upon similar facts in *Hurd Enterprises, Ltd. v. Bruni*.[101] The lessors asked the court to reconsider its decision in *Killam Oil*[102] in light of the Fifth Circuit's decision in *Frey v. Amoco Production Co.*,[103] which interpreted lease royalty provisions that the lessor contended were substantially the same as those before the *Hurd* court. The *Hurd* court distinguished the royalty provisions in the two cases, noting that the federal court construed the *Frey* royalty clause as being triggered by sales, rather than production (which under Louisiana law might include a sale of future production), whereas the royalty provision in *Killam Oil* was triggered only by actual production.[104] "[U]nder Texas law, the term 'production' in oil and gas leases means the actual physical extraction of the mineral from the soil."[105] Be-

98. Of course, the lessor and lessee could have avoided the dispute had they dealt specifically with take-or-pay payments in the lease. For example:

> Lessee agrees to pay Lessor 3/16th royalty on any and all amounts received by the lessee pursuant to take-or-pay clauses, contract buy-outs and contract buy-downs and the Lessor shall have the same rights and remedies herein provided for the payment of royalties.

KUNTZ ET AL, supra note 33 ("Exhibit A": Landowner's Attachment to Oil and Gas Lease (by Robin Stead, Esq.), Form # 5).

Another example is paragraph 3(d) of a lease used by the University of Texas System to lease University Trust Lands:

> Lessor shall share in "take or pay" payments. If any gas purchase contracts, agreements or any amendments thereto entered into by Lessee for the sale or disposition of gas or other products under this Agreement should contain a "take or pay" clause requiring a purchaser of gas to take, or upon failing to take, to pay for the minimum annual contract volume of gas which a producer-seller has available for delivery, then any payments made by such purchaser of gas under such provision, whether or not gas is actually delivered, shall be subject to the payment of royalty to the Lessor as herein provided. Upon written request by Lessor, Lessee shall furnish Lessor complete copies of all such gas purchase contracts or agreements and any amendments thereto entered into by Lessee for the sale or disposition of gas or other products produced under this Agreement.

6 RICHARD W. HEMINGWAY, WEST'S TEXAS FORMS § 4.2 (John S. Lowe Supp. 1995). Query, however, whether this language would extend to buy-out or buy-down payments?

99. *Killam Oil*, 806 S.W.2d at 268.

100. *Id.* (emphasis in original).

101. 828 S.W.2d 101 (Tex. App.—San Antonio 1992, writ denied).

102. 806 S.W.2d 264.

103. 943 F.2d 578 (5th Cir. 1991).

104. *Hurd*, 828 S.W.2d at 106.

105. *Id.* (citing *Killam Oil*, 806 S.W.2d at 267).

cause of the distinguishing royalty clause provisions[106] and the Texas Supreme Court's denial of writ of error in *Killam Oil*, the court of appeals applied the "law of the case" doctrine to *Hurd* and refused to overturn its prior decision.[107]

In *Mandell v. Hamman Oil & Refining Co.*,[108] the Texas Court of Appeals for the First District, Houston, relied heavily upon *Killam Oil* and held that a lessor was not entitled to share in a take-or-pay settlement, even though the lease gave the lessor the right to take royalty in kind and to approve all proposed sales contracts.[109] The court noted that "[t]he lease itself is deemed to express the intent of the parties, unless the terms are ambiguous," and stressed the care with which the terms before it had

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106. In fact, *Hurd* is based upon differences in the royalty clauses' meaning, not their language. The royalty provision in *Frey* provided for a "royalty on gas sold by Lessee [at] one-fifth (1/5) of the amount realized at the well from such sales," (*Frey*, 943 F.2d at 580, *quoted in Hurd*, 828 S.W.2d at 106) while the *Hurd* royalty clause called for royalty "on gas . . . produced from said land and sold or used off the premises [based on market value and] on gas sold at the wells [based on the] amount realized." *Hurd*, 828 S.W.2d at 106. The facts and context of *Killam Oil* and *Hurd* reveal that the issue before the courts was the application of the "amount realized" portion of the royalty clause. This is obvious from the reasoning of *Killam Oil*, which focuses upon whether the take-or-pay payments are part of the "price paid" for gas. *Killam Oil*, 806 S.W.2d at 268. Furthermore, in Texas, "market value" is independent of actual sales, so the price paid or amount realized is logically irrelevant to a market value royalty. Exxon Corp. v. Middleton, 613 S.W.2d 240, 246 (Tex. 1981). *See also* Carter v. Exxon Corp., 842 S.W.2d 393, 397 (Tex. App.—Eastland 1992, writ denied), discussed *infra* text accompanying notes 140-43.

Thus, the royalty clause language in *Frey* and *Hurd* was substantially the same; both called for royalty on gas "sold." The distinction between *Frey* and *Hurd* is in the underlying law. In Louisiana, gas can be "sold" before "production." *See* Frey v. Amoco Prod. Co., 603 So. 2d 166, 176-79 (La. 1992). The Texas Supreme Court has held, however, that "produced" in the lease royalty clause means physical extraction and "sold" means delivered. *Middleton*, 613 S.W.2d at 244 (discussed in *Killam Oil*, 806 S.W.2d at 267). It follows that in Texas gas cannot be sold for royalty clause purposes before it is produced.

See also Energy Oils, Inc. v. Montana Power Co., 626 F.2d 731, 738 (9th Cir. 1980) (lump sum paid as partial consideration for a lease assignment was not "proceeds from the sale of production" for purposes of calculating payout of a farmout agreement); Monsanto Co. v. Tyrrell, 537 S.W.2d 135, 137 (Tex. Civ. App.—Houston [14th Dist.] 1976, writ ref'd n.r.e.) (recoupable advance payment made by a gas purchaser to a producer was not a "recovery from production" that triggered additional royalty). Professor Richard Pierce has distinguished these cases, however, as a reflection of the "court's interpretation of the agreement as a means of creating a production based trigger for converting the plaintiff's interest [from one interest to a more valuable interest]. That purpose would be defeated if the conversion to a more valuable interest were permitted to take place prior to any production." Richard J. Pierce, Jr., *Lessor/Lessee Relations in a Turbulent Gas Market*, 38 INST. ON OIL & GAS L. & TAX'N 8-1, § 8.03[2], n.47 (1987). Professor Bruce Kramer agrees that "production under those 'payout'-type clauses may have a much different meaning than production under a basic landowner's royalty clause." Bruce M. Kramer, *Royalty Obligations Under the Gun — The Effect of Take-or-Pay Clauses on the Duty to Make Royalty Payments*, 39 INST. ON OIL & GAS L. & TAX'N 5-1, § 5.05[2] (1988). I am not so sure, at least about *Tyrrell*. There is no reason that "production" in an additional royalty clause should have a different meaning from "production" in the habendum clause of the same lease. *See infra* notes 182-84 and accompanying text.

107. *Hurd*, 828 S.W.2d at 106. The court also held that there was no special relationship between the lessor and the lessee that would support a finding that the lessee owed the lessor a fiduciary duty, *id.* at 107-11, and no confidential relationship that would give rise to a duty of good faith and fair dealing. *Id.* at 111.

108. 822 S.W.2d 153 (Tex. App.—Houston [1st Dist.] 1991, writ denied).

109. The lessor was not a third party beneficiary of the gas contract either. *Id.* at 161.

been negotiated[110] in concluding that the royalty owner had no right as such to share in the take-or-pay settlement because "[p]roduction is the key to royalty. Royalty does not accrue until gas is produced, that is, physically severed from the soil."[111]

As these cases illustrate, if the courts view the royalty clause as a straightforward and clear statement of the parties' intent and give effect to the "plain terms" of the standard royalty clause, which typically keys royalty to "production" or "sale," lessees need not pay lessors royalty on take-or-pay payments, settlements, buy-outs, or buy-downs because those benefits are not triggered by removal of gas from the ground.[112]

If the courts look behind the words of the royalty clause to canons of construction or extrinsic evidence, however, lessees may be held liable to pay royalty on take-or-pay benefits on reasoning rooted in the minority view of the market value royalty cases. *Frey v. Amoco Production Co.*[113] and *Klein v. Jones*,[114] the only reported appellate cases holding that royalty is due on take-or-pay payments, settlements, buy-outs, or buy-downs,

110. *Id.* at 159-60 (citing Schwartz v. Prairie Producing Co., Inc., 727 S.W.2d 289, 291 (Tex. App.—Houston [1st Dist.] 1987, writ ref'd n.r.e.)).

111. *Id.* at 165 (citation omitted).

112. Other cases denying royalty on take-or-pay payments or settlements are also generally consistent with this analysis. In State v. Pennzoil Co., 752 P.2d 975 (Wyo. 1988), the gas royalty clause provided for royalty on gas "produced from said land and saved and sold or used off the premises." *Id.* at 979. The court held that no royalty was due on take-or-pay payments because the parties did not define their contract terms differently from the common meaning, and production required "severance of the mineral from the ground." *Id.* In Harvey E. Yates Co. v. Powell, No. 90-715-M Civil, slip op. at 2 (D.N.M. Jan. 19, 1994), a federal district court in New Mexico ruled that royalty due on "gas produced and saved" to be calculated upon "net proceeds derived from the sale of such gas in the field" did not extend to take-or-pay payments or settlements because "under the plain language of the state lease, royalty payments are not due to the lessor until the oil or gas is physically extracted." *Id.* slip op. at 6. *Cf.* Kaiser-Francis Oil Co. v. Producer's Gas Co., 870 F.2d 563 (10th Cir. 1989); Associated Gas Distribs. v. FERC, 893 F.2d 349, 359 (D.C. Cir. 1989) (holding that non-recoupable lump-sum payments to settle take-or-pay disputes did not violate the maximum lawful price for first sales under the Natural Gas Policy Act because the "prepayments are not payments for gas to the extent that the gas is not taken.").

113. 603 So. 2d 166 (La. 1992). *Frey* had an interesting procedural history. The Fifth Circuit overruled the district court's holding that under Louisiana law a leasehold royalty owner was not entitled to share in take-or-pay payments or settlements because the payments were neither made in connection with physical production and severance, nor part of the sale price of gas. Frey v. Amoco Prod. Co., 708 F. Supp. 783 (E.D. La. 1989). The lease royalty clause before the district court did not refer to gas "produced," but merely entitled the royalty owner to a percentage of "the amount realized at the well from such sales." *Id.* at 785. The Fifth Circuit distinguished *Diamond Shamrock* on the grounds that the royalty clause in *Diamond Shamrock* required "production," while the clause before it in *Frey* was not so limited. Frey v. Amoco Prod. Co., 943 F.2d 578, 581 (5th Cir. 1991). The court of appeals did not specifically address the royalty owners' implied covenant claims, which the trial court had rejected, though the opinion's dicta may support that claim as well. *Id.* at 583-86. The court also did not distinguish recoupable from non-recoupable payments; Amoco received $66.5 million in take-or-pay payments — one $45.6 million payment that Columbia could recoup over a five-year period by taking volumes above the minimum annual purchase requirement, and one $20.9 million non-recoupable payment. On petition for rehearing, however, the court of appeals certified the question of royalty on take-or-pay payments to the Louisiana Supreme Court. Frey v. Amoco Prod. Co., 951 F.2d 67 (5th Cir. 1992) (per curiam), *cert. granted*, 592 So. 2d 1308 (La. 1992).

114. 980 F.2d 521 (8th Cir. 1992).

assume that the lease royalty provisions are uncertain so that the royalty clause must be given meaning by looking behind the language of the lease to its underlying intent, to implied covenants, or to fundamental fairness.[115]

In *Frey*, the Louisiana Supreme Court began by noting Louisiana's statutory definition of the lessor's royalty:

> any interest in production, or its value, from or attributable to land subject to a mineral lease, that is deliverable or payable to the lessor or others entitled to share therein. Such interests in production or its value are 'royalty,' whether created by the lease or by separate instrument, if they comprise a part of the negotiated agreement resulting in execution of the lease.[116]

The court then adopted the premise that neither party had anticipated the regulatory and market changes that led to take-or-pay settlements, so "we look not at the parties' intent to provide expressly for take-or-pay payments, but rather at the parties' general intent in entering an oil and gas lease . . . reflecting the mutuality of objectives and sharing of benefits inherent in the lessee-lessor relationship."[117] The court characterized the oil and gas lease as a contract[118] in which the lessee "avoids having to pay up front for the privilege of exploration, and the [lessor] . . . is guaranteed participation in any eventual yield accruing from the lessee's entrepreneurial efforts,"[119] and discussed *Wemple v. Producers' Oil Co.*,[120] which held that the doctrine of unjust enrichment required that a lessor whose royalty clause did not refer to casinghead gas be paid royalty on gasoline extracted from casinghead gas,[121] and *Henry v. Ballard & Cordell Corp.*[122] to support its point. Quoting Professor Thomas Harrell, who coined the term,[123] the Louisiana Supreme Court described the oil and gas lease as a "cooperative venture" in which "[a]n economic benefit accruing from the leased land, generated solely by virtue of the lease, and

115. *See also* Roye Realty & Dev., Inc. v. Watson, No. 76,848 (Okla. Ct. App. filed July 14, 1992), *cert. granted*, (Okla. filed Jan. 11, 1993). The appellate court ordered the trial court to compel the lessee and purchaser to produce the settlement agreement and the information relating to payments made under the settlement agreement to the lessors because the lessee had an implied duty to the lessors to market the lessor's oil and gas. The court reasoned that a take-or-pay provision in a gas purchase contract is "simply a marketing substitute," *id.* slip op. at 1, that allows a purchaser to refuse to buy the gas which would otherwise be sold and generate a royalty for the lessors. The issue of royalty on take-or-pay benefits is presently before the Oklahoma Supreme Court as a certified question from the U.S. District Court for the Western District of Oklahoma. Grabow v. Santa Fe Int'l Corp., No. CIV-93-2011-R (W.D. Okla. filed Aug. 31, 1994).

116. LA. REV. STAT. ANN. § 31-213(5) (West 1992) (quoted in *Frey*, 603 So. 2d at 171-72).

117. *Frey*, 603 So. 2d at 172-73.

118. The court classified the oil and gas lease as a "synallagmatic contract" that imposes reciprocal obligations. *Id.* at 173.

119. *Id.*

120. 83 So. 232 (La. 1919) (discussed in *Frey*, 603 So. 2d at 173).

121. *Wemple*, 83 So. at 237. *See* 3A W.L. SUMMERS, OIL AND GAS LAW § 594 (1958), and Hardwicke, *supra* note 13, at 11-14.

122. 418 So. 2d 1334 (La. 1982), discussed *supra* notes 74-82 and accompanying text.

123. Harrell, *supra* note 81, at 336.

which is not expressly negated, is to be shared between the lessor and lessee in the fractional division contemplated by the lease."[124] The court concluded that:

> [w]e interpret the "amount realized" . . . to encompass both: 1) the *total* price paid by Columbia for the natural gas delivered, and 2) the "economic benefits" derived from the lessee's right to develop and explore, a right conferred by the lease.
>
> . . . .
>
> . . . [T]he term "amount realized" connotes the sum total, the whole, or the final effect of the economic benefits obtained by Amoco in the exercise of the rights granted by the synallagmatic contract of Lease, and, is composed, in part, of the advantages flowing to Amoco by virtue of the sale of natural gas under the Morganza Contract.[125]

The court specifically rejected the "plain meaning" approach to the royalty clause: "the duty before us is not to divine the intent of the royalty clause in the abstract. Rather, the process reflects our appreciation of the cooperative nature of the lease arrangement as well as an understanding of the economic and practical considerations underlying the royalty clause."[126]

Klein also accepted the premise that the terms of the royalty clause have no plain meaning.[127] The facts of *Klein* were unusual in that the pipeline simply bought the company that owned the lessees' interests in the producing wells,[128] thus acquiring the right to renegotiate its own take-or-pay contract.[129] Though the Eighth Circuit rejected the lessors' claims that they were owed a fiduciary duty by the producers and its shareholders and were third-party beneficiaries of the gas contract, the court found liability on an unjust enrichment theory, stating that the facts "cry for equity intervention."[130] Noting an unusual Arkansas statute requiring the lessee to share "premiums" or "bonuses" with the lessor,[131] the court observed that:

> a restrictive interpretation of the royalties clause in a conventional lease can be inconsistent with its basic purpose, and can produce re-

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124. *Frey*, 603 So. 2d at 173-74 (citation omitted).

125. *Id.* at 179-80 (emphasis in original).

126. *Id.* at 181.

127. 980 F.2d 521 (8th Cir. 1992). The court noted a "developing recognition that a restrictive interpretation of the royalties clause in a conventional lease can be inconsistent with its basic purpose, and can produce results that are unintended by the parties, and unfair to the lessor." *Id.* at 531.

128. The largest shareholder bought out was Jerry Jones, *id.* at 523, who used some of the proceeds he received to purchase the Dallas Cowboys football team. The Cowboys have undoubtedly proved to be a better investment than most oil and gas deals.

129. *Id.* A class of approximately 3000 royalty owners sued for a share of the purchase price. *Id.* The district court granted summary judgment to the lessees because the royalty owners had not stated a case. *Klein*, 980 F.2d at 526. The district court would have permitted the royalty owners to recover for breach of the implied covenant to market, but the statute of limitations barred such a claim. *Id.*

130. *Id.* at 527.

131. *Id.* at 529.

> [H]ornbook law . . . [requires that the clause be] construed in favor of the lessor, if for no other reason than that the lessor is the uninformed and inexpert party to the bargain.[132]

The court recognized what it termed the "Harrell rule" that a lease is a "cooperative venture . . . for the mutual benefit of both parties,"[133] and remanded the case to the trial court.[134]

The take-or-pay royalty cases have caused a monumental and ironic "flip-flop" in the positions of lessees and lessors.[135] Oil companies generally complained bitterly that the majority rule on the meaning of "market value" was unfair because their gas was sold as soon as it was under contract. They now sing the virtues of a rule that prevents royalty from being due until there is "production." Royalty owners' counsel in states that follow the minority rule on market value royalties, who missed out on the market value litigation frenzy, now contemplate relatively easy pickings from suits claiming a share of take-or-pay settlements.

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132. *Id.* at 531 (citing 2 W.L. SUMMERS, OIL AND GAS LAW 372 (1958)).

133. *Klein*, 980 F.2d at 531-32.

134. *Id.* at 533. When *Klein v. Jones* was considered on remand, the federal district court held for the lessees on both the unjust enrichment and implied covenants theories. Klein v. Jones, No. 90-2060, slip op. (W.D. Ark. filed Jan 5, 1994). The court concluded that there could be no unjust enrichment under Arkansas law because the lessees "had the legal right to sell their interests . . . (including the take-or-pay claim) and cannot be said to have been unjustly enriched because they chose to exercise that legal right." *Id.* slip op. at 35. The take-or-pay provision compensated the lessee for the risk of drilling. Because the lessors were at most incidental beneficiaries of the gas contract, the "benefits incidently acquired by plaintiffs . . . were in like manner incidently lost" when the contract was prudently bought down. *Id.* slip op. at 44-45. The lessees had satisfied their duty to market when they obtained a price equal to or greater than the market price of gas then currently being produced or sold, *id.* slip op. at 62-63, because the settlement permitted the sale of gas that the purchaser had not been willing to take as well as the drilling of additional wells. *Id.* slip op. at 48-49. Even with a breach of the implied covenant, there would have been no damages, *Klein*, slip op. at 63, because the amended contract price was greater than the available market price. *Id.* slip op. at 40.

Ultimately, however, the Eighth Circuit resoundingly reaffirmed its position. In Klein v. Arkoma Prod. Co., No. 94-1353, 1996 WL 5660 (8th Cir. Jan. 11, 1996), the Eighth Circuit held that the district court had failed to follow its mandate. The circuit court stated that it had held in Klein v. Jones that, as a matter of law, the transactions among Arkoma and its shareholders, on the one hand, and the Arkla entities, on the other, amounted to a settlement of the royalty owners' take-or-pay claims, for which the Arkoma shareholders received a premium price for their stock that was subject to royalty on an unjust enrichment theory. *Id.* at *3-*4. Further, the court stated, the transactions breached the implied covenant to market, because:

> [t]he implied covenant to market . . . necessarily encompasses not only the duty to make prudent and reasonable business decisions, but the duty to share the proceeds of those decisions with the lessors. The breach in this case is neither the decision to settle, nor the decision to reform the contract, but the failure to share the benefits of the settlement with the beneficial owners of those proceeds.

Id. at *5. In my view, the court's implied covenants analysis confuses the reasonable prudent operator standard with the royalty obligation. *See infra* note 180.

135. Bondurant, *supra* note 24, at 590 n.90, notes "the ironic situation of attorneys for royalty owners adopting the arguments of gas producers set out in the market value royalty cases and attorneys for producers responding with the royalty owners' former arguments."

IV. THE IMPLICATIONS OF PRECEDENT FOR DISPUTES OVER ROYALTY ON TAKE-OR-PAY BENEFITS

The two lines of market value and royalty on take-or-pay cases, while equally valid in their logic, are irreconcilable.[136] It is ludicrous to conclude that lessors and lessees in adjoining states intended such sharply different meanings for the same lease terms or such varied financial impacts as the market value and royalty on take-or-pay decisions have brought. The fundamental interpretative principles[137] have not been consistently applied to lease royalty disputes.

The lines of cases do, however, suggest the competing analyses that the courts are likely to follow, not just in take-or-pay disputes,[138] but in other royalty obligation disputes as well. States that adopted the *Vela* rule in the market value royalty disputes are likely to refuse to extend the royalty obligation beyond the plain terms of the royalty clause, while those states that followed the reasoning of *Tara* may award royalty on such payments.[139]

A. "Plain Terms" Jurisdictions

In jurisdictions that define the royalty obligation by looking to the plain terms of the royalty clause, a "market value" royalty cannot logically include take-or-pay payments, settlements, buy-outs, or buy-downs because market value is what a willing buyer and seller would agree upon when the gas is produced and is independent of the amount the lessee receives for gas sold. This approach to "market value" royalty clauses is particularly appropriate in jurisdictions applying the *Vela* rule. So long as the lessee pays the lessor a royalty at least equal to the market value of the gas when it is produced, the lessor should have no complaint. *Carter v. Exxon Corp.*[140] illustrates the reasoning. In *Carter*, the Texas Court of Appeals in Eastland held that a lease calling for royalty based upon "market value at the well" did not allow the market value of gas used to manufacture liquid products to be determined by "working back" from the sales price of the liquid products.[141] The court reasoned that the "at

136. This statement is not made lightly. I spent three weeks fruitlessly trying to develop a theory to rationalize these cases.

137. *See supra* notes 32-47 and accompanying text.

138. Some commentators have treated royalty on take-or-pay payments and royalty on take-or-pay settlements, buy-outs or buy-downs as separate issues. *See, e.g.*, Pierce, *supra* note 106, at 8-19 to 8-20; John S. Lowe, *Current Lease and Royalty Problems in the Gas Industry*, 23 Tulsa L.J. 547, 563 (1988). As Professors Smith and Weaver have noted, however, the arguments are virtually identical. 1 Ernest E. Smith & Jacqueline L. Weaver, Texas Law of Oil and Gas § 4.6(E)(6), at 210 (1994). Therefore, I shall not make such a distinction in this Article.

139. *See supra* text accompanying notes 49 to 58, for a list of jurisdictions that appear to have adopted one rule or the other on the meaning of market value.

140. 842 S.W.2d 393 (Tex. App.—Eastland 1992, writ denied).

141. *Id.* at 397. *Carter* is merely the final step, however, in well-established reasoning. The courts have long recognized that determining market value requires a look at the existing markets. *See, e.g.*, Phillips Petroleum Co. v. Ochsner, 146 F.2d 138, 141 (5th Cir. 1944) and Phillips Petroleum Co. v. Record, 146 F.2d 485 (5th Cir. 1944) (where gas had no

the well" reference of the lease called for royalty to be determined "for gas that is produced in its natural state, not on the components of the gas that are later extracted."[142] Furthermore, "[m]arket value is to be calculated the instant the gas is produced from the reservoir. . . . The liquid products valuation method is, therefore, not permitted by the leases because it involves a determination of market value after the gas is produced."[143]

Take-or-pay benefits logically could be subject to royalty, nevertheless, under a lease calling for royalty based upon "amount realized," "amount received," or "proceeds" even in a state that has adopted the *Vela* rule to govern market value disputes. Though "market value" in such a state is independent of the lessee's actual receipts, "amount realized," "amount received," or "proceeds" is based upon those receipts.

The issue then becomes whether to treat the take-or-pay benefit as received for "production." On this, the cases are inconsistent.

The Louisiana Supreme Court in *Frey* considered take-or-pay benefits to be additional proceeds for gas that had already been produced:

> Because the producer is willing to negotiate a lower price in exchange for the guarantee the pipeline will either take or pay for a specific minimum quantity of natural gas, the take-or-pay provision effectively lowers the price the producer charges the pipeline per unit of gas. Consequently, absent the take-or-pay provision, the price of gas, and thus the royalty owed thereon, would be higher.[144]

In *Diamond Shamrock*, the Fifth Circuit rejected the idea that take-or-pay payments are additional proceeds for gas previously produced, in part because take-or-pay payments are not for "production."[145] Subsequent administrative actions involving federal leases, however, have attempted to distinguish between past and future production and between take-or-pay payments and take-or-pay settlements, buy-outs, or buy-downs. Though the Department of the Interior initially acquiesced in the result of *Diamond Shamrock,*[146] in the early months of the Clinton ad-

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value at the well, except for the manufacture of gasoline, evidence of prices paid elsewhere for gas for light and fuel was inadmissible). When there is a viable free market and the gas being valued is available to go to that market, the free market should value the royalty.

142. *Carter*, 842 S.W.2d at 397. The court relied upon Sowell v. Natural Gas Pipeline Co. of Am., 789 F.2d 1151 (5th Cir. 1986).

143. *Carter*, 842 S.W.2d at 397. Presumably, market value is to be determined by working back from the hub spot market price if there is no market at the well. *See* Hardwick & Hayes, *supra* note 24, at 11-22. David E. Pierce, *supra* note 24, at § 18.01.

144. *Frey*, 603 So. 2d at 180 (citation omitted).

145. *Diamond Shamrock*, 853 F.2d at 1165. *See supra* notes 87-94 and accompanying text.

146. *See* Revision of Gross Proceeds Definition in Oil and Gas Valuation Regulations, 53 Fed. Reg. 45,082 (1988) (amending Department of the Interior regulations codified at 30 C.F.R. § 206 (1988)). *See also* Blackwood & Nichols Co., Ltd., [10 Royalty Valuation & Mgmt.] Gower Fed. Serv. (Rocky Mtn. Min. L. Found.) MMS-88-0008-O&G (Dept. of the Interior, Apr. 20, 1989) (MMS Director reversed assessment calling for royalties on unrecoupable buy-out payment); and Wolverine Exploration Co., [10 Royalty Valuation & Mgmt.] Gower Fed. Serv. (Rocky Mtn. Min. L. Found.) MMS-88-0052-IND (Dept. of the Interior, May 2, 1990) (MMS Director reversed assessment of royalties on non-recoupable

ministration the Minerals Management Service (MMS) issued a "Dear Payor" letter to all those who paid royalty under federal or Indian leases.[147] The "Dear Payor" letter stated a rationale for claiming royalty on take-or-pay settlements, buy-outs, and buy-downs, notwithstanding *Diamond Shamrock.* The letter reasoned that production of the bought-out or bought-down volumes "continues from the lease under any successor contract with any purchaser during the term of the original contract,"[148] because the payment "compensates the lessee for lower prices in the future."[149] By this reasoning, when production occurs within the term of the original contract but after a settlement, it triggers a royalty on the proportionate part of settlement payments.

In *Samedan Oil Corp.*,[150] the Department of the Interior considered claims by the MMS, based upon the "Dear Payor" letter, to share in take-or-pay contract buy-out payments made by a pipeline purchaser to Samedan.[151] The Department of the Interior adopted the reasoning of the letter,[152] noting that the "Dear Payor" letter "simply reflects the established principle that the lessee's gross proceeds consist of the total consideration paid to the lessee for the sale of gas produced from the lease"[153] and characterizing the amounts paid to buy out Samedan's gas purchase contract as attributable to gas Samedan subsequently sold on the spot market:

> Samedan effectively received two payments for gas it produced. It received the amount from the successor purchasers . . . on which it has already paid royalties. It also received the additional $89,706.00 from [the pipeline]. It is simply illogical to categorize the payment

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settlement of take-or-pay obligation though the pipeline had make-up rights at the time of the settlement and gas was produced and sold after the settlement).

147. *See* "Dear Payor" Letter, [D Royalty Valuation & Mgmt.] Gower Fed. Serv. (Rocky Mtn. Min. L. Found.) at 9-635 (Dept. of the Interior, May 3, 1993).

148. *Id.* at 9-639.

149. *Id.*

150. [16 Royalty Valuation & Mgmt.] Gower Fed. Serv. (Rocky Mtn. Min. L. Found.) MMS-94-0003-IND (Dept. of the Interior, Sept. 16, 1994). The Department of the Interior reached a similar result in Shell Offshore, Inc., [13 Royalty Valuation & Mgmt.] Gower Fed. Serv. (Rocky Mtn. Min. L. Found.) MMS-91-0087-DLS (Dept. of the Interior, Sept. 2, 1994). For a discussion of *Samedan*, see Michael J. Henke, *Rhubarb Over Royalties*, NAT. GAS, Dec. 1994, at 29.

151. As the federal district court noted in *Samedan*, federal leases provide for royalties based upon "value." *Samedan*, slip op. at 21. Regulations expand that term, however: "[U]nder no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable transportation allowances and processing allowances . . . ." 30 C.F.R. § 206.152(h) (1994) (unprocessed gas); *see also id.* § 206.153(h) (processed gas). "Gross proceeds" are further defined as the "total monies and other consideration accruing to an oil and gas lessee for the disposition of" production. *Id.* § 206.151. *See also id.* § 206.150 (Indian leases). A history of federal royalties may be found in John L. Price, *Evolution of Federal Royalty Management Regulation*, 45 INST. ON OIL & GAS L. & TAX'N § 6.01 (1994).

152. The "Dear Payor" letter was not a binding order or regulation. It merely stated the position of the MMS' Associate Director for Royalty Management. *Samedan*, slip op. at 9.

153. *Id.* at 10.

from [the pipeline] as anything but a payment that Samedan received for gas it produced.[154]

The Department of the Interior concluded that, because "[t]he payment . . . is made in anticipation of the producer receiving a lower price for gas if production continues,"[155] the buy-out payments were subject to royalty during the term of the bought-out contract on a monthly production basis.[156] The payment "is part of what the lessee receives for the gas when it is delivered, and effectively is no different from a prepayment."[157] This analysis, the Department of the Interior reasoned, would result in royalties on buy-out payments only when the gas was actually produced, which complies with *Diamond Shamrock*'s "actual production requirement."[158]

When *Samedan* was appealed to a federal district court in *Independent Petroleum Ass'n of America v. Babbitt*,[159] the MMS was upheld. The IPAA and Samedan argued on appeal that the Department was bound by *Diamond Shamrock* and that *Samedan* was inconsistent with *Diamond Shamrock*.[160] The court distinguished *Samedan* from *Diamond Shamrock*, however, largely following the reasoning of the "Dear Payor" letter. The court noted that *Diamond Shamrock* did not deal with whether royalty was due on lump sum settlements.[161] Quoting the "Dear Payor" letter at length,[162] the court accepted the Department of the Interior's construction of "gross proceeds" to include take-or-pay buy-outs and non-recoupable payments for accrued liabilities.[163] The court reasoned that the settlement payments were " 'part of the benefit which the lessee derives from that production.' "[164] The court further argued that the interpretation was necessary to avoid unjust enrichment, because "[i]f producers were permitted to retain 100% of non-recoupable settlement payments, . . . producers would have an incentive to negotiate with pipelines for large non-recoupable payments in exchange for drastically reduced future gas prices," which might breach the implied covenants to

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154. *Id.* at 15.

155. *Id.* at 17.

156. The buy-out price is divided by the total estimated future production volumes bought out to determine an amount per MMBtu. This amount is then added to the amount realized from sale on a monthly basis as gas is actually produced for the remainder of the term of the bought-out contract. *Id.* at 13.

157. *Samedan*, slip op. at 17.

158. *Id.* at 30.

159. Nos. 93-2544 and 94-2123, 1995 U.S. Dist. LEXIS 10163, *1 (D.C. June 14, 1995). This decision has been appealed. *IPAA v. Babbitt* is only the beginning of what will likely be a long process of testing the implications of the reasoning of the Fifth Circuit in *Diamond Shamrock*.

160. *IPAA* at *22. Samedan also urged (and the court rejected) a variety of procedural grounds, most notably that the "Dear Payor" letter constituted a rule-making for which the government had failed to follow the procedures required by the Administrative Procedures Act. *Id.* at *7-*18.

161. *Id.* at *23.

162. *Id.* at *33-*35.

163. *Id.* at *35.

164. *IPAA* at *34 (quoting *Samedan*, slip op. at 17).

market or operate prudently.[165] The court rejected Samedan's argument that settlement payments were merely a substitute for damages for breach of contract, which would not be subject to royalty, as "interesting, but irrelevant. The case at hand does not involve damages."[166]

The Department of the Interior's reasoning in *Samedan* and *IPAA* was resoundingly rejected by another district court, however, in *In re Century Offshore Management Corp.*,[167] an appeal from a summary judgment in a Chapter 11 bankruptcy proceeding. Century possessed a gas contract with Enron Corporation that called for payment of non-recoupable take-or-pay payments.[168] The parties agreed to terminate the agreement for a lump sum payment based upon the present value of the non-recoupable payments.[169] During Century's reorganization, the MMS claimed additional royalties of more than $1,800,000 based upon the reasoning of the "Dear Payor" letter and the decisions applying it.[170] The bankruptcy court rejected the claim and granted summary judgment for the debtor on the basis of *Diamond Shamrock*.[171] The district court for the Eastern District of Kentucky affirmed, holding that the claim for royalty on the take-or-pay settlement exceeded the MMS' authority and was arbitrary and capricious.[172] MMS had exceeded its authority because:

> Enron's payment to Century was not for present or future deliveries of severed natural gas to Enron; rather it was to terminate Enron's future obligations . . . . A royalty is not due on a take-or-pay payment because that payment was not made for severed gas but rather because the purchaser failed to purchase gas. By interpreting "gross

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165. *Id.* at *35-*36.

166. *Id.* at *37. The court concluded with "a word about risk allocation," *id.* at *38-*39, refuting *Diamond Shamrock*'s observation that lessors do not "shoulder the associated risks of exploration, production and development." *Diamond Shamrock*, 853 F.2d at 1167. The court identified three risks that an oil and gas lease might allocate between lessor and lessee: "(1) fluctuations in market price; (2) lower-than-expected recoverable quantities of gas; and (3) cost overruns in exploration, development, and production." *IPAA* at *39. The court concluded that an oil and gas lease is structured "to share price and quantity risks while assigning all cost risk to the lessee," *id.* at *41, so that "any alteration of price or quantity risk by the lessee — e.g., via take-or-pay provisions or settlements of various types—should be shared by the lessor." *Id.* Noting that "[e]ven non-recoupable take-or-pay revenues would be royalty-bearing if this risk-sharing logic is accepted," *id.* at *42, the court concluded that "[w]ith all due respect to the Fifth Circuit, this court would not find that DOI had violated its statutory authority if it were to adopt regulations" making take-or-pay revenues subject to royalty even without make-up production. *Id.*

The court's reasoning appears flawed. As the *Diamond Shamrock* court used the term, "cost risk" means "exploration, production, and development costs," which the lessee must bear alone. Furthermore, the force of the argument goes to whether the lessee has breached an implied covenant, rather than to the royalty obligation. *See infra* note 180.

167. 185 B.R. 734 (E.D. Ky. 1995).

168. *Id.* at 736-37.

169. *Id.* at 737.

170. *Id.*

171. *Id.* The bankruptcy judge's scathing rejection of the MMS' claims, which formed the basis for the reasoning of the district court, may be found at Judgment, No. 93-51340 (Bankr. E.D. Ky. filed Feb. 13, 1985). The bankruptcy court ridiculed the *Samedan* reasoning because "[t]he MMS' argument that Enron's payment was a prepayment for gas is the exact same argument that . . . was rejected by the Fifth Circuit." *Id.* at 10.

172. *In re Century Offshore Management*, 185 B.R. at 740.

proceeds" to include payments made not for natural gas, but rather to terminate a contractual obligation, the MMS exceeded its . . . authority.[173]

The court set out several reasons that it considered the MMS' claim arbitrary and capricious. First, the MMS' interpretation would require two royalty payments—one on the production itself and another on the settlement proceeds allocated to the sale.[174] Second, since the purpose of the take-or-pay payment provision is to apportion the risks of development and production between the buyer and seller of gas—risks that the lessor disclaims by leasing—"it would be irrational to let the government share in any revenues that the producer realized by taking those risks."[175] Third, the two-year limit on refunds for royalty overpayments[176] would often deprive producers of the opportunity to claim refunds because of the government's failure to pursue its claims between 1988 and 1992.[177] Finally, "it is nonsensical to claim that any portion of the settlement payment is part of the 'fair market value' of gas sold at a later time under a different contract," because "if the purchaser does not take gas under the original gas purchase contract, there is no market for that gas."[178] The Kentucky federal district court refused to follow *IPAA v. Babbitt,* which it had reviewed and considered, because it was not binding and was still on appeal to the District of Columbia Circuit.[179]

Ultimately, I submit that the reasoning that led some courts to adopt the *Vela* rule in the market value disputes should also preclude those courts from concluding that take-or-pay benefits are the "amount realized," "amount received," or "proceeds" from production.[180] The plain

173. *Id.* (citation omitted).

174. *Id.* at 741.

175. *Id.*

176. 43 U.S.C. § 1339 (1988).

177. *In re Century Offshore Management*, 185 B.R. at 741.

178. *Id.*

179. *Id.* at 742. The court also held that the MMS' claim was based upon an interpretation that was unlawfully retroactive. *Id.* at 741.

180. It is possible, of course, that courts in states that have adopted the *Vela* rule will grant royalty owners a share of take-or-pay payments, settlements, buy-outs, or buy-downs on some other theory, such as that the royalty owner is a third-party beneficiary; that the lease is a relational contract; or that the lessee has breached the implied covenant to market. *See* 3A W. L. SUMMERS, THE LAW OF OIL AND GAS § 589A at 42-44 (John S. Lowe Supp. 1995). Of these theories, the implied covenant to market theory is the strongest, but its strength varies with the facts. Clearly there is an implied covenant that the lessee will market the lessor's gas at the best available price. It does not logically follow, however, that the lessor is entitled to share in every payment to the lessee. The lessee's obligation is generally expressed as that of a reasonable prudent operator, not that of a fiduciary or guarantor. The lease is a business deal, and the appropriateness of the parties' actions should be judged by the standards of business, rather than the precepts of trusts or insurers. While imposing liability for failure to pay royalty on take-or-pay benefits is "but a step," John S. Lowe, *Current Lease and Royalty Problems in the Gas Industry*, 23 TULSA L.J. 547, 563 (1988), from recognition of an implied obligation to market at the best available terms, we may expect to see courts reject lessors' demands to share in take-or-pay payments based on an implied covenants theory. The payments are commercially reasonable in the gas industry and do not adversely affect the lessor's right to receive royalty when the gas is produced and sold.

meaning of words like "production" and "sale," usually found in royalty provisions, simply does not encompass take-or-pay benefits or other payments made in lieu of production.[181] The royalty compensates the lessor for the lessee's maintenance of the lease during the secondary term. Courts in most states have required severance of oil and gas to constitute "production" to maintain an oil and gas lease during the secondary term.[182] If "production" for habendum clause purposes requires sever-

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Claims for a share of take-or-pay settlements, buy-downs, and buy-outs, however, may be another story. The classic and easy application of the implied covenant to market occurs when a lessee exchanges a benefit that the market or a contract would allocate to its lessor for a benefit to itself or to some other lessor. That is precisely what happens in most take-or-pay settlements. Generally, the lessee receives a cash payment in exchange for either a release or a modification of volume or price obligations imposed upon the purchaser by the gas contract. In either event, the lessee trades contract terms that benefit both the lessor and the lessee for terms that benefit only the lessee. In this situation, the lessee's judgment should be scrutinized under the reasonable prudent operator standard on a case-by-case basis. If the lessee's judgment or the structure of the settlement fails to meet this standard, there is a strong argument that the benefits of the settlement, buy-down, or buy-out should be shared proportionately.

There are two caveats to this analysis. First, even if one concludes that the lessee has breached the implied covenant to market in a particular circumstance by settling take-or-pay claims or in structuring a take-or-pay settlement in a particular way, it does not necessarily follow that the appropriate measure of the lessor's damage is the royalty share of the benefits that the lessee received. The damage may be greater (e.g., royalties based upon the "old" contract price) or lesser (e.g., the difference between the "new" contract price and what the court finds that the lessee should have obtained for the lessor).

Second, in Texas, the lessor's remedy under the implied covenant to market theory apparently is precluded by the definition of "production." In Mandell v. Hamman Oil & Ref. Co., 822 S.W.2d 153 (Tex. App.—Houston [1st Dist.] 1991, writ denied), the court rejected the lessor's implied covenants claim for a portion of a take-or-pay claim settlement, stating:

> A lessee's covenants to its lessors pertain to *production* of gas. . . . Under the marketing covenant, the lessee must make certain that *gas that is produced* is sold for the best price or under the best terms.
>
> Take or pay is not a payment for production; it is a payment for nonproduction. . . . A take or pay payment that comes before gas is actually produced and taken cannot be a payment for the sale of gas.
>
> Production is the key to royalty. . . . We hold that take or pay is not a benefit that [the lessors] received via execution of the lease with [the lessee] and does not flow from the marketing covenant of the lease. [The lessee] was required to obtain for [the lessors] only benefits received that were related to the sale of gas that had been produced.

Id. at 164-65 (citations omitted).

181. As the Texas Supreme Court noted in Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex. 1981), "for royalty to become payable, gas must be 'produced from said land and sold or used off the premises. . . .' Production means actual physical extraction of the mineral from the land. Under the royalty clause, production of gas is a prerequisite to its sale or use." *See also Piney Woods*, 726 F.2d at 234 ("a gas sale contract is executory and . . . no particular gas is sold until it is identified—i.e., brought to the surface. . . . Shell could not 'sell' the gas . . . because a 'sale' consists in the passing of title . . . . "); State v. Pennzoil Co., 752 P.2d 975, 980 (Wyo. 1988) ("Neither Pennzoil or [sic] Marathon could acquire any interest (title) in the gas which they could transfer to CIG until it was produced and severed from the land. It could not be produced and severed until it had been brought to the surface.").

182. *See* 2 EUGENE O. KUNTZ, THE LAW OF OIL AND GAS § 26.6 (1995).

ance,[183] it is "somewhat unlikely that the parties intended for 'production' to mean something different when used in the royalty clause."[184]

The case against a royalty claim for buy-out or buy-down payments is particularly strong in a jurisdiction predisposed to a "plain meaning" interpretation. The whole point of a buy-out or buy-down is to relieve the producer from the obligation to produce and the purchaser from the duty to take production or pay for non-production. Moreover, in a buy-out, there is typically no legal or economic connection between the original contract and what the MMS termed "the successor agreement."[185] In *Samedan*,[186] SONAT made the buy-out payment, while TransOk and Hadson bought the released gas on the spot market.[187] Thus, concluding that "the amount paid by the original purchaser to be relieved of its obligation to take the gas is part of the benefit which the lessee derives from that [future] production"[188] ignores both the royalty clause and the economic reality of the transaction.[189]

B. Cooperative Venture Jurisdictions

Eventually, even courts that are not constrained by precedent[190] probably will adopt the cooperative venture analysis. But the cooperative venture theory does not require finding royalty due on take-or-pay benefits.

183. Indeed, by this logic even "production," by itself, may not trigger royalty, because most states require actual production marketed in paying quantities. John S. Lowe, Oil and Gas Law in a Nutshell 186-87 (3d ed. 1995). Sondrol v. Placid Oil Co., 23 F.3d 1341 (8th Cir. 1994), held that royalty owners with a proceeds royalty clause were not entitled to royalty on stored gas until the gas was sold and proceeds were received by the lessee. *Id.* at 1344. The lessee was unable to sell all of the gas it produced because there was no market for it, so the lessee stored the gas and sold it several years later when prices had dropped. When the stored gas was sold, the lessee paid royalty based upon the sales price. *Id.* at 1343. The Sondrols contended that they were entitled to royalties on the stored gas when it was stored based on the price of gas at the time of production. The Eighth Circuit disagreed, holding that "proceeds" means "the money obtained from an actual sale," so that production that generates no cash proceeds or tangible, non-monetary consideration triggers no royalty requirement. *Id.* at 1344 (quoting Matzen v. Cities Serv. Oil Co., 667 P.2d 337, 347 (Kan. 1983), *cert. dismissed*, 472 U.S. 1023 (1985)).

184. Smith & Weaver, *supra* note 138, at 211-13.

185. *Samedan*, slip op. at 17.

186. *Id.*

187. *Id.* at 3.

188. Independent Petroleum Ass'n of Am. v. Babbitt, Nos. 93-2544 and 94-2123, 1995 U.S. Dist. LEXIS 10163 at *25 (D.C. June 14, 1995).

189. In fact, Hurd Enters. Ltd. v. Bruni, 828 S.W.2d 101, 104 (Tex. App.—San Antonio 1992, writ denied), *see supra* notes 101-07 and accompanying text, apparently involved a contract buy-out.

190. Even a court in a jurisdiction that has never directly addressed the market value or royalty on take-or-pay issues may feel bound by other plain meaning interpretations of the jurisdiction. Whether or not words have plain meaning is not an issue limited to royalty disputes. *See, e.g.*, Carbon County v. Union Reserve Coal Co., 898 P.2d 680, 687 (Mont. 1995) (holding plain meaning of grant of "coal and coal rights" was to sever coalbed methane gas from the coal estate).

1. The Merits of Cooperative Venture Analysis

At least three factors support the conclusion that the cooperative venture theory will become widely accepted.

First, the theory that the lease is a cooperative venture makes sense in lease transactions. Stating royalty as a percentage of production or its value is a hedge against the inherent uncertainties of mineral development.[191] If the parties could anticipate with reasonable certainty the quantity of the substances that they would find, they might fix a lump sum or a unit price for royalty. With oil and gas, however, the presence of the substance, let alone its quantity, is uncertain. Therefore, the parties to a lease or royalty instrument typically express royalty as a portion of production or its value if oil or gas is produced. If production is prolific, the royalty interest benefits proportionately more from the percentage royalty than if production is slight. Essentially, the lease is an economic partnership between the lessor, who owns the minerals, and the lessee, who possesses the money and expertise to develop the minerals.[192] "Cooperative venture" is an accurate description.

Second, examining the plain terms of the lease to determine which payments the royalty should share makes little sense in the context in which leases are made and used. Experience suggests that the parties to oil and gas leases make no fine distinction between "market value" and "amount realized" or "sale" and "production" in lease forms.[193] "[G]enerally the only apparent intention of the parties is for the lessor to get no less than other lessors and the lessee to pay no more than other lessees."[194] Furthermore, before the mid-1980s, neither lessors nor lessees contemplated the kind of environment in which oil and gas are now produced and sold.[195] A typical lease royalty clause has plain meaning only in the context of traditional sales in the field; we are doing business in the age of the computer chip with lease forms drafted (and sometimes executed) in the age of the Model A Ford.

Finally, the history of royalty disputes also supports the cooperative venture theory. The cases denying royalty owners a share of take-or-pay payments or settlements have generally reasoned that royalty is due upon production, and there is no production until the gas has been physically

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191. This principle has long been recognized. *See* EUGENE O. KUNTZ ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 248 (2d ed. 1993); R.S. MORRISON & EMILIO D. DE SOTO, OIL AND GAS RIGHTS 41 (1920).

192. John S. Lowe, *Representing the Landowner in Oil and Gas Leasing Transactions*, 31 OKLA. L. REV. 257, 268 (1978). Because the lessee possesses the operating rights, the position of the lessor might be seen as akin to a limited partner. *Id.* at 269.

193. Both lessors and lessees are generally aware that relatively few oil and gas leases are ever drilled. Lessors typically focus on the size of the bonus and delay rentals being offered. Lessees typically focus on acquiring the right to drill rather than paying the royalty on a successful well. In fact, most leases are taken by lease brokers or contract landmen on printed forms commonly used in the area, rather than on forms crafted by the ultimate lessee.

194. Sneed, *supra* note 13, at 643.

195. *See supra* notes 1-11.

severed from the ground.[196] While it is historically true that royalty has been tied to production, that may be so because royalty has been payable in kind, and without production there would be no in-kind royalty. Where royalty is due in cash, however, nothing in the history of the royalty clause bars a broader concept of royalty.[197] Indeed, early oil and gas leases looked very much like joint venture agreements and often did not even use the term "royalty."[198]

Recent cases on the analogous claims of the states and federal government to royalty on tax reimbursements may be a harbinger of the direction that the cases will take. *Enron Oil & Gas Co. v. Utah Department of Natural Resources*[199] is an example.[200] In *Enron*, the Utah Supreme Court affirmed an assessment of royalty by the Division of State Lands and Forestry on ad valorem and severance tax reimbursements paid to Enron in accordance with gas purchase contracts for gas produced from state lands.[201] Under the terms of its leases, Enron was obligated to pay a 12½% royalty based on the " 'reasonable market value at the well of all gas produced and saved or sold from the leased premises' " but " 'in no event shall the price for gas be less than that received by the United States of America for its royalties from gas of like grade and quality from the same field.' "[202] The court ruled that "the stated price plus tax reimbursements constitute the consideration that a willing buyer pays a willing seller and together they equal the 'reasonable market value' of the gas,"[203] specifically rejecting the dissent's argument that Enron had received the tax reimbursements in return for its commitment of the gas to contract rather than as part of the price for the gas.[204] The court said that "[t]here is . . . no practical difference between consideration for the gas and consideration for a commitment to a long-term contract."[205]

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196. *See supra* notes 89-112 and accompanying text.

197. "Production is not the only way a producer receives value from an asset; federal agricultural price supports, for example, pay farmers for *not* producing crops." White, *supra* note 24, at 668.

198. *See, e.g.*, the oil and gas leases quoted in Leslie Moses, *The Evolution and Development of the Oil and Gas Lease*, 2 INST. ON OIL & GAS L. & TAX'N 1, 6-7 (1951) and lease form II in GEORGE BRYAN, THE LAW OF PETROLEUM AND NATURAL GAS 416-18 (1898).

199. 871 P.2d 508 (Utah 1994).

200. There are many such cases. *See also* Enron Oil & Gas Co. v. Department of Revenue & Taxation, 820 P.2d 977, 982 (Wyo. 1991) ("Purchasers . . . are clearly willing to pay not only the maximum price permitted by the NGPA, but also a price enhanced by the reimbursement of both the severance and ad valorem taxes assessed by the State of Wyoming."); Cities Serv. Oil & Gas Corp. v. State, 838 P.2d 146, 155 (Wyo. 1992) ("what is to be the amount is the actuality created in finite result."); Enron Oil & Gas Co. v. Lujan, 978 F.2d 212, 215 (5th Cir. 1992) (holding that state severance tax reimbursements may be included as part of a lessee's gross proceeds when calculating royalty valuation of gas production).

201. *Enron*, 871 P.2d at 510.

202. *Id.* at 509 (quoting Utah Code Ann. § 65-1-18, repealed by Laws 1988 ch. 121, § 18 [sic]).

203. *Id.* at 510.

204. *Id.* at 511.

205. *Id.* It is interesting to note that the court did not overrule, and addressed only indirectly, the decision of the Utah Court of Appeals in Belnorth Petroleum Corp. v. State Tax Comm'n, 845 P.2d 266, 269-70 (Utah Ct. App. 1993), which held that reimbursements

The royalty disputes in severance tax cases are distinguishable from lessor/lessee royalty disputes, of course, because courts tend to defer to the claims of public agencies.[206] In addition, severance tax reimbursements are paid for production and sale of gas under the contracts that provide for the reimbursements, rather than in lieu of production; a severance tax reimbursement is more easily characterized as part of the price of gas produced and sold than is a take-or-pay benefit. The reasoning of the royalty on severance tax cases,[207] however, illustrates the attraction of the cooperative venture theory. The private royalty owner is surely as much a partner in the producer's economic venture as is the state.

2. *Are Take-or-Pay Benefits Within the Cooperative Venture?*

In states that treat the oil and gas lease as a cooperative venture, particularly those that have adopted the *Tara* reasoning that market value must normally be based upon contract price, royalty owners are more likely to win royalty on take-or-pay benefits than in plain terms jurisdictions.[208] The premise that the terms of the royalty clause lack a plain meaning opens the door to considering the lease a cooperative venture. If there is no plain meaning, the courts are free to look behind the words to the relationship of the parties.

Describing the lease as a cooperative venture does not settle the issue, however. The problem becomes how to describe the payments. In economic terms, a take-or-pay payment is a deficiency-based demand charge[209]—a payment for the lessee's agreement to hold gas from the

for occupational and conservation taxes, while part of the total value of the gas contract, were not part of the value of the gas itself for royalty purposes. *Id.* at 268.

206. *See also* Mesa Operating Ltd. Partnership v. Department of the Interior, 931 F.2d 318, 326 (5th Cir. 1991), *cert. denied*, 502 U.S. 1058 (1992) (holding that the Department of the Interior might properly include reimbursements for gas treatment costs within gross proceeds for royalty purposes).

207. Cases relating to the application of state severance taxes to severance tax reimbursements may also support royalty on take-or-pay benefits. In 3300 Corp. v. Marx, 633 So. 2d 1028, 1034 (Miss. 1994), the Mississippi Supreme Court held that reimbursements for severance taxes by a gas purchaser are part of the "sales price" of gas and, therefore, subject to severance taxes. Mississippi levies a severance tax upon persons producing or severing natural gas. MISS. CODE ANN. § 27-25-703 (1972 & Supp. 1994). The tax is measured by the value of the gas and is assessed at 6% of the value, which is defined as "the sales price, or market value." *3300 Corp.*, 633 So. 2d at 1030. Noting that the tax reimbursement was " 'simply a novel way to increase the sales price of the gas,' " *id.* at 1031 (quoting the brief of the Tax Commission), the court held that the reimbursement received by 3300 Corporation should be considered part of the price the purchaser was willing to pay for the gas and therefore subject to taxation. *Id.* at 1034. *See also* State v. Moncrief, 720 P.2d 470 (Wyo. 1986).

208. By my count, only Louisiana, Oklahoma, and Arkansas have followed the *Tara* reasoning.

209. A demand charge is an amount paid to have a service or a specified volume of the commodity available, and does not vary with actual use. For example, the flat charge for local service from the telephone company is a demand charge. A demand charge is usually contrasted with a commodity charge, a payment for the amount of a service or commodity actually received. A commodity charge is based upon actual use. A deficiency-based demand charge is triggered only if an agreed reservation of service is not used.

spot market for delivery to a particular contract.[210] By this view, the take-or-pay payment compensates the lessee for its commitment of service, not for the sale of a good.[211] Take-or-pay settlements, buy-outs, or buy-downs likewise may be seen as compensation for the market risk that the lessee took in choosing to develop, rather than as amounts received for gas.[212]

On the other hand, as the Louisiana Supreme Court concluded, "the right not to take gas is merely a corollary of the right to take gas. . . . Columbia would not have bargained for the right not to take gas although paying as if it had, without having the right to take gas."[213] In the context in which gas contracts with take-or-pay clauses were generally executed—long-term commitments of specific leases to specific gas contracts—there is a strong argument that payments, settlements, buy-outs, or buy-downs were benefits of the cooperative venture and so should be shared by the parties. The Louisiana Supreme Court may have had commitment in mind when it noted in *Frey* that:

> The benefits which accrue to Amoco under the Morganza Contract *are derivative of the rights transferred* to Amoco by Frey. Clearly, *but for the Lease there would be no Morganza Contract, no Settlement Agreement, and ultimately no take-or-pay payments made to Amoco.* *Henry*, supra, is authority for this determination. Therefore, even if we failed to find the take-or-pay proceeds constitute part of the price received by Amoco for the sale of natural gas, the payments nonetheless are economic benefits which accrue to the lessor under the rationale of *Henry*. See also *Wemple*, supra.[214]

There are at least two flaws in this reasoning. First, it relies heavily upon unjust enrichment theory. Second, it ignores the historical and logical limits to the royalty obligation.

a. The Effect of Unjust Enrichment Theory

Both the Louisiana Supreme Court in *Frey* and the Eighth Circuit in *Klein* relied heavily on unjust enrichment analysis.[215] It is unclear, however, whether other states that have adopted the *Tara* rule for the market value disputes—particularly Oklahoma—will give unjust enrichment the weight that the *Frey* and *Klein* courts gave it. The Oklahoma Supreme

210. *Diamond Shamrock*, 853 F.2d at 1167. *See also* KUNTZ ET AL., *supra* note 191, at 251.

211. Other methods of description may lead to the same result. *See* Hurd Enters., Ltd. v. Bruni, 828 S.W.2d 101, 104 n.3 (Tex. App.—San Antonio 1992, writ denied) ("The purpose of the take-or-pay provision is to give the producer a continuous, stable, and assured source of revenue to cover the fixed charges such as service on its indebtedness, maintenance costs, and its initial capital investment." *Id.* (citing SMITH & WEAVER, *supra* note 138, at 211, and *Diamond Shamrock*, 853 F.2d at 1167)).

212. *Diamond Shamrock*, 853 F.2d at 1167.

213. Frey v. Amoco Prod. Co., 603 So. 2d 166, 178 (La. 1992) (citation omitted).

214. *Id.* at 180-81 (emphasis added). The court cited Henry v. Ballard & Cordell Corp., 418 So. 2d 1334 (La. 1982) and Wemple v. Producers' Oil Co., 83 So. 232 (La. 1919). Interestingly, however, commitment does not appear essential to *Frey*'s reasoning.

215. *See supra* notes 113-34 and accompanying text.

Court was concerned about fairness to both lessors and lessees in *Tara*[216] but never mentioned unjust enrichment. Indeed, the Oklahoma jurisprudence in the casinghead gasoline cases, the royalty dispute perhaps most analogous to the royalty on take-or-pay benefits debate, is very different from that of Louisiana.

Early oil and gas leases rarely contained specific royalty provisions covering casinghead gas.[217] Leases drafted before casinghead gas became valuable typically provided for a one-eighth royalty on oil but for a flat rental on gas wells.[218] The proliferation of motor vehicles and the explosion of technology between 1910 and 1920[219] made the extraction of gasoline from casinghead gas extremely profitable and led to disputes over whether royalty was due on casinghead gas as oil or gas royalty. In *Wemple v. Producers' Oil Co.*,[220] the Louisiana Supreme Court applied the theory of unjust enrichment and held that the lessor was due an oil royalty upon casinghead gasoline extracted unless the lessee could show that the extraction of casinghead gasoline involved proportionately greater expense than oil production.[221] When the Oklahoma Supreme Court confronted this problem, however, it reasoned that since casinghead gasoline was not mentioned in either royalty clause provision, it was neither oil nor gas, and ownership of casinghead gas remained in the lessor.[222] The court concluded that the lessee who produced casinghead gasoline was a good faith trespasser, entitled to recover only the reasonable costs of production from gasoline revenues.[223] The court specifically declined to make an "equitable contract" for the parties[224] because that was "not a power conferred upon the court."[225] This case and others that followed similar reasoning[226] suggest that although Oklahoma will probably recognize the cooperative venture theory, the state courts may hesitate to extend it to make the lessor and the lessee share take-or-pay benefits.[227]

216. 630 P.2d at 1272-75.

217. SAMUEL H. GLASSMIRE, OIL AND GAS ROYALTIES 50 (2d ed. 1930). Casinghead gas is wet gas produced along with oil. WILLIAMS & MEYERS, *supra* note 3, at 142.

218. *See, e.g.*, BRYAN, *supra* note 198, at 416-18; A.E. WILKINSON & J.A. RICHARDSON, THE LAW OF OIL AND NATURAL GAS 142-47 (1915) (Forms VI and VII).

219. In 1914, there were approximately 1,600,000 cars, 85,000 trucks, and 17,000 farm tractors in the United States. RUTH S. KNOWLES, THE GREATEST GAMBLERS 156 (1959). By 1918, there were 5,600,000 cars, 525,000 trucks, and 44,000 farm tractors. *Id.*

220. 83 So. 232 (La. 1919).

221. *Id.* at 238.

222. Hammett Oil Co. v. Gypsy Oil Co., 218 P. 501, 504 (Okla. 1923).

223. *Id.*

224. *Id.* at 505.

225. *Id.* at 506.

226. *See* SUMMERS, *supra* note 121, § 595.

227. Lest the argument that precedent will bind the courts of any particular jurisdiction be taken too far, it should be noted that in Texas, the bastion of plain terms interpretation, the courts held in the casinghead gasoline disputes that the royalty clause required royalty on casinghead gas from which gasoline was extracted. Reynolds v. McMan Oil & Gas Co., 11 S.W.2d 778 (Tex. 1928) (involving a royalty clause identical to that in *Hammett Oil*); Livingston Oil Corp. v. Waggoner, 273 S.W. 903 (Tex. Civ. App.—Amarillo 1925, writ ref'd). One commentator has suggested that the result in these cases was designed to "prevent injustice," and that under a plain terms interpretation the result should have been

In addition, both *Frey* and *Klein* were based in part upon unusual state statutes that may expand the royalty obligation on an unjust enrichment theory. The Louisiana statute defines the lessor's royalty to include "[s]uch interests in production or its value . . . *whether created by the lease or by separate instrument*, if they comprise a part of the negotiated agreement resulting in execution of the lease."[228] The Arkansas statute imposes upon the lessee the duty to "protect the royalty of the lessor's interest by paying to the lessor or his assignees the same price, including such premiums . . . and bonuses of whatsoever name for royalty oil or gas that is paid the . . . lessee . . . for the working interest."[229] Most states, including Oklahoma, apparently have no such legislation. Thus, to the extent that *Frey* and *Klein* were based upon statutory language, they may stand alone.

b. Inherent Limits to the Royalty Obligation

The "but for" reasoning of *Frey* creates a Palsgrafian[230] chain of causation that might make virtually every benefit obtainable to a lessee subject to royalty. For example, must a lessee pay royalty on its profits from the sale of a lease to a third party? What if a lessee discovers a well on the leased property, greatly increasing both the value of its other properties in the area and the lessee's stock? Is royalty due on the increase in stock value? If a lessee delivers gas to a fertilizer plant owned by the lessee and uses the gas as feed stock for fertilizer, is the lessor entitled to the royalty share of fertilizer profits? In each case, the lessee's profits are derivative of the rights transferred and would not have existed but for the existence of the lease.

Frey goes too far. Independently of whether one believes oil and gas leases are cooperative ventures between lessors and lessees, there are inherent limits to the royalty obligation that may affect the lessors' right to claim royalty on take-or-pay benefits and other payments to lessees. History and logic suggest that the scope of the royalty obligation should be

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different, because "[u]nder the Texas view that an oil and gas lease conveys the oil and gas in place . . . the lessee was privileged to produce the casinghead gas but under no express duty to pay a royalty therefor." SUMMERS, *supra* note 121, § 596.

228. LA. REV. STAT. ANN. § 31:213(5) (West 1989) (emphasis added) (quoted in *Frey*, 603 So. 2d at 172).

229. ARK. CODE ANN. § 15-74-705 (Michie 1987). Interestingly, a prior codification of this statute was dismissed as "inapplicable" after it had been asserted by the lessors to convert fixed price leases to proceeds leases. Hillard v. Stephens, 637 S.W.2d 581, 586 (Ark. 1982).

230. In Palsgraf v. Long Island R.R., 162 N.E. 99 (N.Y. 1928), the classic case on proximate causation in torts, railroad employees assisting a passenger aboard a train leaving the station dislodged a package the passenger was carrying. The package contained fireworks that exploded and caused scales located on the station platform to tip over and injure Ms. Palsgraf. On appeal from a trial court's decision in favor of Ms. Palsgraf based upon "but for" or direct causation analysis, the New York Court of Appeals (in an opinion by Justice Benjamin Cardozo) reversed the trial court, holding that tort liability for negligence required both (1) a breach of a duty toward the plaintiff and (2) harm to the plaintiff that is reasonably foreseeable. *Id.* at 100-01.

limited to the fruits of lessees' production functions,[231] which typically occur at or near the wellhead, and should not extend to entrepreneurial functions such as marketing, transportation or processing.[232]

i. *History of the Royalty Obligation*

Historically, the royalty obligation has excluded entrepreneurship. Royalty[233] has always been due "at the well,"[234] where the product from which the royalty is paid comes into being. In the Middle Ages, the British Crown held title to all land. After enfeoffment of the feudal lords, the King retained a "royalty" right to take gold or silver that might be found in the lands he had conveyed.[235] When the King alienated the right to mine, he typically reserved part of all the ore to be delivered "on top of the ground free of charge," which was also called "royalty."[236]

The civil law embodied a concept of royalty similar to that of the common law. Spanish law recognized the *dominio radical*, literally the "root ownership," the King's ownership of minerals contained in the soil of the

231. Though I hesitate to list it as support, my colloquial experience of nearly 25 years dealing with lessors and lessees also supports the distinction between the production function and marketing and other enhancements to production. Lessors do not generally expect to share in the benefits (or the risks) of the lessee's entrepreneurship. They instinctively think of the lease as a cooperative venture limited to development of the leased property.

232. Others have also suggested that the courts should distinguish the production function from value-enhancing functions such as gathering, marketing, and processing in defining the royalty obligation. *See, e.g.*, Maxwell, *supra* note 24, § 15.03; R. Pierce, *supra* note 24, at 8-19 to 8-21. *Cf.* John S. Lowe, *The Meaning of "Payout" in Oil and Gas Farmout Agreements*, 10 E. MIN. L. INST. § 13.01, § 13.05[2], at 13-46 (1989).

233. Royalty comes to the oil and gas industry from the feudal system in England, SAMUEL H. GLASSMIRE, LAW OF OIL AND GAS LEASES AND ROYALTIES § 10, at 55-56 (1935), where it was developed to distinguish the share of production reserved by the Crown from the production rights of those granted the right to work mines and quarries. HARRIET S. DAGGETT, MINERAL RIGHTS IN LOUISIANA 247 (1949). "Royalty" was also used in feudal England in the context of landlord/tenant relations. Feudal lords received title to land directly from the Crown as a reward for services and on the condition that they would render future services. Feudal lords in turn permitted their tenants to cultivate the land in return for a share of the products of the tenants' efforts. Feudal tenants held only a "working interest" in land, producing crops at their own labor and expense. The share of the products given to landlords by tenants was also termed "royalty" since it was the portion accruing to the landowners as a result of the royal grant or favor. Taylor v. Peck, 116 N.E.2d 417, 418 (Ohio 1953). *See also* GLASSMIRE, *supra* note 217, at 19. The form of a grant of the right to develop minerals, with a concomitant royalty to the mineral owner, was adopted over the years for natural resources development generally. The modern U.S. oil and gas lease evolved from forms used in the manufacture of salt from brine water, which in turn developed from solid minerals mining leases, and still clearly reflects its origins. Moses, *supra* note 198, at 10.

234. Generally, the cases interpret "at the well" to mean "within the lease boundaries." Skaggs v. Heard, 172 F. Supp. 813, 815 (S.D. Tex. 1959); Exxon Corp. v. Middleton, 613 S.W.2d 240, 243 (Tex. 1981).

235. A.J. THUSS, JR., TEXAS OIL AND GAS § 117 at 156 (2d ed. 1935). The grant of the colony of Pennsylvania to William Penn by King Charles II in March of 1681 illustrates the system of royal patronage in early colonial times. The royal patent reserved "one-fifth of all the gold and silver discovered in the region." GLASSMIRE, *supra* note 233, at 56. The King clearly appreciated the value of a royalty, although he did not anticipate the substantial value that a royalty on coal, oil, and gas would have yielded. *Id.*

236. THUSS, *supra* note 235, at 156.

lands of his subjects.[237] The King's right derived from the Mining Ordinance of 1783—itself promulgated by Charles III, the greatest of the Spanish Bourbons—which listed royal minerals and set forth a procedure by which subjects could produce them.[238] The ordinance authorized a miner's royalty to the King, the *derecho del quinto* ("the tax of the fifth part").[239]

In the United States, "market value," "amount realized," and "market price" were used in lease royalty clauses, sometimes interchangeably, to describe a royalty at the production point, before the lessee applied its entrepreneurship to enhance value by transporting, processing or marketing the gas.[240] The fact that leases used before gas processing made sales at the tailgate common used "market value," "market price at the well," and "amount realized at the well" interchangeably suggests that the parties thought that the precise term used was of little importance and that the lessor and lessee would share proportionately the benefits of the sale of production in the area of the lease.

ii. The Logic of the Cases

Courts have frequently recognized that a lessee is entitled to entrepreneurial uses of production without sharing benefits. In *Wilkins v. Nelson*,[241] the Louisiana Supreme Court denied a royalty owner's claim to a share of gasoline revenues where gasoline was extracted from a well producing only gas and the lease provided for a flat rental for gas. The court did not mention unjust enrichment.[242] In *Phillips Petroleum Co. v. Record*[243] and *Phillips Petroleum Co. v. Ochsner*,[244] the Fifth Circuit held that royalty under a "market value at the well" royalty clause was due based on the value of the gas at the well for use in the manufacture of gasoline. This was despite the fact that the lessee actually exchanged the gas produced with another who used the gas to generate heat and light,

237. "[N]o mention of minerals needed to be made in title papers granting or patenting land. . . . Land grants simply had nothing to do with minerals and did not affect their ownership." WALACE HAWKINS, EL SAL DEL REY 9 (1947).

238. *Id.* at 7-9.

239. *Id.* at 9. The ordinance also entitled a surface owner to damages for use of the surface by a miner. *Id.*

240. *See, e.g.*, CURTIS M. OAKES, BENOIT'S OIL AND GAS FORMS 7 (2d ed. 1939) ("To pay lessor . . . the equal one-eighth (1/8) of the gross proceeds at the prevailing market rate"), *quoting* Producers' 88 Standard Lease Form; GLASSMIRE, *supra* note 217, at 28 ("one-eighth of the gross proceeds of the gas at the prevailing market rate"); RICHARD L. BENOIT, CYCLOPEDIA OF OIL AND GAS FORMS 171 (1926) ("one-eighth of the net proceeds, based on the market or selling price at the well"). *See also* Wall v. United Gas Pub. Serv. Co., 152 So. 561, 562 (La. 1934) ("one-eighth (1/8) of the value of such gas calculated at the market price per thousand feet"); George Siefkin, *Rights of Lessor and Lessee with Respect to Sale of Gas and as to Gas Royalty Provisions*, 4 INST. OF OIL & GAS L. & TAX'N 181, 214 (1953) ("the equal one-eighth (1/8) of the *gross proceeds at the prevailing market rate*, for gas used off the premises") (emphasis in original), discussing the royalty clause in a typical Kansas lease.

241. 99 So. 607 (La. 1924).

242. *Id.* at 609.

243. 146 F.2d 485 (5th Cir. 1944).

244. 146 F.2d 138 (5th Cir. 1944).

uses that commanded a higher price but which had no established market at the well.[245] The court noted:

> Lessee did not sell the gas. It simply traded it for an equal quantity of the same kind and of the same market value in another part of the field for use in its gasoline plant there. It received the gas as owner under its lease, and it was obligated to pay appellee the market value at the well, no more and no less, and this without regard to the use made of it.[246]

In *Sowell v. Natural Gas Pipeline Co. of America*,[247] the court held that gas royalties based on the average market price being paid for gas in a six-county area were paid for all of the constituents of that gas, including gas liquids collected in "drip pots" between the wellhead, the metering station and the processing plant. The court reasoned that, because production triggers the obligation to pay royalty, the rights and obligations of the parties should be assessed at the wellhead.[248] After the industry restructuring of the 1980s, in *Carter v. Exxon Corp.*,[249] a Texas court of appeals held that a lease calling for royalty based upon "market value at the well" did not permit the royalty owner to share in revenues generated by the lessee in manufacturing liquid products downstream from the well because "at the well" requires royalty to be determined on "gas that is produced in its natural state, not on the components of the gas that are later extracted."[250]

Substantial indirect case law also supports excluding entrepreneurial functions from the royalty obligation. Implied covenant cases, for example, have recognized that while the lessee's implied covenants may require the installation of a booster on the lease to force gas into a pipeline[251] or construction of a plant to permit carbon dioxide production,[252] there is no implied obligation to construct a pipeline to permit gas to be marketed.[253] The lessee has a duty to act on or near the lease to make production possible to take advantage of a market but has no duty to act away from the lease to create a market.[254]

245. *Id.* at 139-40.

246. *Id.* at 141 (citing Gulf Prod. Co. v. Taylor, 28 S.W.2d 914 (Tex. Civ. App.—Eastland 1930, writ dism'd); Lone Star Gas Co. v. Stine, 41 S.W.2d 48 (Tex. Comm'n App. 1931, judgm't adopted); Humble Oil & Ref. Co. v. Poe, 29 S.W.2d 1019 (Tex. Comm'n App. 1930, judgm't adopted).

247. 789 F.2d 1151 (5th Cir. 1986).

248. *Id.* at 1157-58.

249. 842 S.W.2d 393 (Tex. App.—Eastland 1992, writ denied). *See supra* notes 140-43 and accompanying text for further discussion of *Carter*.

250. *Carter*, 842 S.W. 2d at 397 (relying on Sowell v. Natural Gas Pipeline Co. of Am., 789 F.2d 1151 (5th Cir. 1986)).

251. Swamp Branch Oil & Gas Co. v. Rice, 70 S.W.2d 3 (Ky. 1934).

252. *See, e.g.*, Libby v. De Baca, 179 P.2d 263 (N.M. 1947) (upholding a lease cancellation for breach of the covenant to reasonably develop where the lessee had discovered carbon dioxide on a 23,000-acre lease but failed to construct a dry ice plant needed to produce and market the gas).

253. *See, e.g.*, Ashland Oil & Ref. Co. v. Staats, Inc., 271 F. Supp. 571 (D. Kan. 1967); Fey v. A.A. Oil Corp., 285 P.2d 578 (Mont. 1955).

254. *See* 5 WILLIAMS & MEYERS, *supra* note 3, § 856.1. *See also* Siefkin, *supra* note 240, at 203-09.

More directly relevant to the distinction between the lessee's production function and entrepreneurial activities are the cases recognizing that royalty is due at the well, rather than downstream, even when the lease does not stipulate that the calculation is "at the well."[255] *Wall v. United Gas Public Service Co.*[256] is the classic case. In *Wall* the relevant lease royalty clause provided that when gas was sold or used off the premises, "the grantor shall be paid one-eighth (1/8) of the value of such gas calculated at the market price."[257] Gas from the well was transported about two miles and sold, along with gasoline extracted from the gas stream, for 5.8 cents per MCF.[258] The lessees paid royalty based upon the market price of the gas at the well, approximately four cents per MCF.[259] The lessors sued, contending that royalty should be based upon the price for which the gas was sold off the lease after transportation.[260] The Louisiana Supreme Court ruled in favor of the lessee, reasoning that "the parties intended that, if there was a market for gas in the field, the current market price there should be paid. There is where the gas was reduced to possession and there is where ownership of it sprang into existence."[261] Thus, the scope of the cooperative venture is limited; the oil and gas lease is a venture to develop a producing well, and the wellhead is "where the parties come into ownership of the commodity."[262] The cooperative venture theory ought not extend to downstream entrepreneurial functions of the lessee.

Finally, the rationale of the cases that recognize that royalty is subject to post-production costs also indirectly supports a royalty obligation that excludes entrepreneurship. It is axiomatic that the working interest must bear all of the costs of producing oil or gas; royalty is free of costs incurred "at the well" because those costs are required to create the production from which the royalty share comes. It is equally clear, however, that where royalty is valued at the well by working back from downstream sales,[263] costs incurred by the working interest to move or im-

255. *See* Siefkin, *supra* note 240, at 191-203.
256. 152 So. 561 (La. 1934).
257. *Id.* at 562.
258. *Id.*
259. *Id.*
260. *Id.* at 563.
261. *Wall*, 152 So. at 563.
262. *Id. See* Sartor v. United Carbon Co., 163 So. 103, 104-05 (La. 1935). *See also* Sowell v. Natural Gas Pipeline Co. of Am., 789 F.2d 1151 (5th Cir. 1986); Phillips Petroleum Co. v. Record, 146 F.2d 485 (5th Cir. 1944); Phillips Petroleum Co. v. Ochsner, 146 F.2d 138 (5th Cir. 1944); and Danciger Oil & Ref., Inc. v. Hamill Drilling Co., 141 Tex. 153, 171 S.W.2d 321 (1943). *Cf.* Shamrock Oil & Gas Corp. v. Price, 364 S.W. 260 (Tex. Civ. App.—Amarillo 1963, no writ).
263. Royalty is valued at the well by working back from a sale price only if better data establishing value is not available. The courts take a pragmatic approach: "Market value is a question of fact. . . . [T]he point is to determine the price a reasonable buyer would have paid . . . at the well when produced." *Piney Woods*, 726 F.2d at 238-39. *See also* Montana Ry. Co. v. Warren, 137 U.S. 348 (1890). Sales at the wellhead at the time of production are the best evidence of value. In the absence of the producer's breach of the implied covenant to market or the existence of circumstances that distort the economics of the transaction, such as commitment to a long-term fixed-price contract, an actual arms-length sale at

prove the product must be deducted from the downstream sales price,[264] whether the royalty clause calls for royalty based upon "market value" or "proceeds."[265] The value of any commodity depends upon its proximity to market, and the value of oil or gas normally increases as it moves closer to the burnertip. Thus, post-production costs tend to increase the value of the product and must be deducted from the downstream sales

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the wellhead establishes market value. Cabot Corp. v. Brown, 754 S.W.2d 104, 107 (Tex. 1987). Sales similar in time, quantity, quality, and availability to market are the favored proof of value where there are no sales at the wellhead. Ashland Oil, Inc. v. Phillips Petroleum Co., 554 F.2d 381, 387 (10th Cir. 1975), *cert. denied*, 434 U.S. 968 (1977); *accord Ochsner*, 146 F.2d at 141. "The absence of an available market does not mean that the [product] lacks value, however." Scott Paper Co. v. Taslog, Inc., 638 F.2d 790, 799 (5th Cir. 1981). The courts use a work-back method of royalty valuation, by which value at the wellhead is established by deducting costs incurred by the working interest from the downstream sales price to work back to value at the wellhead, where there are no comparable sales in the area of the well:

> Effective application of this [work-back] method requires selection of an appropriate starting value in the form of a processing stage whose product possesses a value certain; accurate assessment of the costs accruing between the known stage and the one in question is also essential. In developing a resource from a raw material into a finished product, each production stage will add economic value to what was initially only the value of the raw material. The value added at each stage of production is essentially the cost of resources used in taking the material through that stage of production. The work-back method essentially establishes at each production stage the value of the product at that point. By subtracting out all production costs, the value of the raw material is revealed.

Ashland Oil, Inc. v. Phillips Petroleum Co., 463 F. Supp. 619, 620 (N.D. Okla. 1978), *aff'd in part, rev'd in part*, 607 F.2d 335 (10th Cir. 1979), *cert. denied*, 446 U.S. 936 (1980). "A starting place for the work-back method can be any point in the production-processing-sale chain where a dollar figure can be established by reliable evidence . . . ." *Ashland Oil Co.*, 607 F.2d at 336. The work-back valuation method " 'is the least desirable method of determining market price.' " *Piney Woods*, 726 F.2d at 239 (quoting Montana Power Co. v. Kravik, 586 P.2d 298, 303-04 (Mont. 1978)); *See also Ashland Oil*, 554 F.2d at 387.

The hierarchy of royalty valuation methods is intuitive. Market value is what a willing buyer and willing seller would agree upon under the circumstances. *Ashland Oil*, 463 F. Supp. at 626; State v. Carpenter, 126 Tex. 604, 89 S.W.2d 979 (1936); Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 830 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.). Where gas is actually sold at the wellhead in a transaction negotiated at the time of sale, all elements of the definition and the transaction are in congruity unless the sale is not at arms length or the parties act unreasonably; thus, an actual sale at the wellhead is the best evidence of value.

Comparable sales illustrate an available market and are strong evidence of value where there are no actual sales. The circumstances of comparable sales, however, will never be completely the same as the circumstances at the wellhead. *Ashland Oil*, 554 F.2d at 386 (rejecting a determination of value based on data covering "a broad time span and a wide geographical distribution, [because] [t]he transactions . . . were too remote in time or place.").

The work-back method is the hardest valuation method to use accurately because it begins furthest from the wellhead. There are likely to be more variables to consider, although the work-back method "can be just as accurate as any other method . . . ." *Id.* at 387; *see also Piney Woods*, 726 F.2d at 240.

264. Post-production costs typically include transportation, compression, and processing, as well as certain severance and gross production taxes. *See* 3 EUGENE O. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 40.5 (1995); 3 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW §§ 645-645.3 (Supp. 1994). *See also* Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995).

265. *Piney Woods*, 726 F.2d at 241.

price to obtain an accurate valuation "at the well."[266] It should follow that no royalty is due on revenues generated by a lessee's downstream or entrepreneurial activities.[267]

The historical and logical distinction between the lessee's production and entrepreneurial functions suggests an additional reason why even courts that view the lease as a cooperative venture may refuse to extend the royalty obligation to include take-or-pay benefits. If the scope of the cooperative venture is limited to production and marketing in the area of the lease, as history and logic indicate, take-or-pay benefits may then be seen as part of the entrepreneurship of the lessee, compensation to the lessee for committing gas to a particular buyer.[268] This reasoning is not conclusive, however, because the take-or-pay clause may also be viewed as part of the benefits provided by the market available in the field for the gas that the lessee committed to contract at the time of the contract, and thus a benefit derived from the lessee's production function.[269]

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266. *Id.*

> [I]n the analytical process of reconstructing a market value where none otherwise exists with sufficient definiteness, all increase in the ultimate sales value attributable to the expenses incurred in transporting and processing the commodity must be deducted. The royalty owner shares only in what is left over, whether stated in terms of cash or an end product.

Freeland v. Sun Oil Co., 277 F.2d 154, 159 (5th Cir.), *cert. denied*, 364 U.S. 826 (1960). *See also Piney Woods*, 726 F.2d at 240; *Piney Woods*, 539 F. Supp. at 971.

The same reasoning is sometimes stated in equitable terms. Because oil or gas increases in value as it nears the burnertip, calculating royalty on the downstream sales price without deducting the costs incurred in moving the product and improving its quality would unjustly enrich the royalty owner, whose royalty is due at the well, at the working interest owner's expense. *Freeland*, 277 F.2d at 159; *See also Piney Woods*, 539 F. Supp. at 971; Coyle v. Louisiana Gas & Fuel Co., 144 So. 737 (La. 1932); Miller v. Buck Creek Oil Co., 269 P. 43 (Wyo. 1928).

267. Indeed, in *Frey*, the Louisiana Supreme Court implicitly recognized limits to its cooperative venture theory that parallel the distinction that I urge between lease development and entrepreneurship:

> In light of *Henry*, we conclude an oil and gas lease, and the royalty clause therein, is rendered meaningless where the lessee receives a higher percentage of the gross revenues generated by the leased property than contemplated by the lease. The lease represents a bargained-for exchange, with the benefits flowing directly from the leased premises to the lessee and the lessor, the latter via royalty. An economic benefit accruing from the leased land, *generated solely by virtue of the lease*, and which is not expressly negated, is to be shared between the lessor and lessee in the fractional division contemplated by the lease.

Frey, 603 So. 2d at 174 (emphasis added) (citation omitted). By this analysis, the court could just as easily have found that revenues generated by take-or-pay payments, buydowns, or buy-outs were incidental to the lease because they flowed primarily from the entrepreneurship of the lessee.

268. There is some indirect historical support for this conclusion. We know that take-or-pay clauses have been present in gas contracts for many years. *See* Ben R. Howell, *Gas Purchase Contracts*, 4 INST. ON OIL & GAS L. & TAX'N 151, 168-74 (1953). We know, as well, that take-or-pay payments have been made previously. I have found no cases prior to those discussed in this Article, however, in which royalty owners have sought royalty on such payments.

269. In fact, in the 1970s and 1980s, pipeline companies used high take-or-pay commitments as substitutes for price competition, which was barred by the federal gas regulatory scheme. John S. Lowe, *Gas Contracting: The Lessons of the Seventies*, 3 NAT. RESOURCES & ENV'T 3, 5 (1989).

In sum, while the cooperative venture theory is likely to gain wide acceptance, in fact if not name, whether or not a court adopts that theory should not determine whether royalty is due on take-or-pay benefits. The cases that have proceeded from recognition of the cooperative venture theory to liability for royalty on take-or-pay benefits may be distinguished by their reliance upon equitable principles and special statutes. Further, if the lease is a cooperative venture between lessor and lessee, history and logic dictate that the venture is limited to lease development and does not extend to entrepreneurial activities. The real issue is how to characterize take-or-pay benefits, and the problem is that they may fairly be categorized either as within the scope of the cooperative venture or as the fruits of the lessee's entrepreneurship.

V. ROYALTY ON OTHER BENEFITS IN THE RESTRUCTURED MARKET

As is noted above, deregulation of the gas industry spawned a variety of sophisticated financial devices that producers and purchasers use to hedge their risks and increase their profits.[270] The revenues that producers receive from such devices will certainly become the subject of royalty claims. The royalty obligation principles discussed above relating to royalty on take-or-pay benefits may help solve this next wave of royalty disputes.

A. "PLAIN TERMS" JURISDICTIONS

In jurisdictions wedded to the concept of a royalty obligation that is tied to the "plain terms" of the royalty clause, pre-production entrepreneurial activities of the lessee[271] ought not be subject to royalty because there is no "production" or "sale" of production at the time of the transaction. *Monsanto Co. v. Tyrrell*,[272] where plain terms analysis resulted in the holding that a recoupable advance payment made by a gas purchaser to a lessee for future production was not a "recovery from production" that triggered a provision for additional royalty, seems to herald Texas' approach to such issues.

On the other hand, current demand charges or production-based bonuses are certainly tied to production.[273] Such payments may not be treated as "amounts realized" subject to royalty, however, if a court distinguishes between the production function and entrepreneurial activities of the lessee in defining the royalty obligation. A demand charge or a production-based bonus for deliveries is not payment for lease produc-

270. See *supra* notes 15-30 and accompanying text.

271. Pre-production entrepreneurial activities include transactions such as the sale of production in place, gas inventory charges, reservation fees, hedges, and forward trades.

272. 537 S.W.2d 135 (Tex. Civ. App.—Houston [14th Dist.] 1976, writ ref'd n.r.e.).

273. "Demand charge" and "commodity charge" are defined and discussed *supra* note 209.

tion, but rather reflects the value of the lessee's commitment or performance.[274]

B. Cooperative Venture Jurisdictions

In jurisdictions that view the lease as a cooperative venture, the analysis of this Article suggests that the Louisiana Supreme Court certainly went too far when it suggested in *Frey* that royalty is due on the "whole . . . of the economic benefits obtained . . . in the exercise of the rights granted by the . . . Lease."[275] The court's language has raised concern that even indirect benefits of take-or-pay settlements, buy-outs and buydowns, such as access to transportation or favorable transportation rates, might be considered an "amount realized" from the sale of gas under the cooperative venture theory.

If one also accepts that history and logic limit the royalty obligation to lease development functions, however, the Louisiana Supreme Court's statement exceeded its reasoning. In cooperative venture theory states, the outcome of disputes over whether benefits received by a producer are part of the "amount realized" within the meaning of the royalty clause should turn upon the nexus between the production function that constitutes the cooperative venture and the payment. If the payment in question is proximately related to lease development, then royalty will be due. On the other hand, if the payment is "entrepreneurship compensation," a payment generated by the deal-making abilities of the producer rather than by the intrinsic value of the oil and gas that comes out of the well, royalty will not be due.

This analysis suggests that courts in jurisdictions that adopt the cooperative venture theory will likely reject royalty claims on prepurchases, production payments, gas inventory charges, reservation fees, hedges, swaps,

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274. This analysis may be unpersuasive where the demand charge and commodity charge are contained in the same contract clause. For example, consider the following gas contract provision:

> The price for gas shall be a two-part charge composed of a reservation charge and a commodity charge calculated as follows:
>
> (a) The reservation charge shall be _____ per MMBTU and for monthly billing purposes shall be multiplied times the MDQ, the production of which is then multiplied times the number of days in the month.
>
> (b) The commodity charge shall be determined on a monthly basis and shall be an amount equal to the index price for spot gas delivered in _____ as reported in the _____ publication of _____ plus (or minus) _____ per MMBTU. For monthly billing purposes the commodity charge shall be multiplied times the quantity of gas nominated for the month.
>
> (c) Buyer shall be responsible for paying the amounts billed each month pursuant to the pricing formula in accordance with section _____ hereof.

4 W.L. Summers, Oil and Gas Law § 762 n.35 (John S. Lowe Supp. 1995).

Though the reservation charge and the commodity charge are conceptually different, the two are added together to make "price" under the contract, which may lead a court to subject both charges to royalty. Like take-or-pay payments, however, the reservation charge pays for the producer's agreement to supply gas, not for gas produced. Moreover, gas contracts that contain such two-part charges typically do not commit or dedicate specific leases to their performance.

275. *Frey*, 603 So. 2d at 180.

collars and other exotic financial transactions of lessees involving gas supplies in the deregulated market. Such payments reflect the lessee's business expertise rather than the value of the product created by the cooperative venture of the lease. Likewise, producers should not generally be subject to royalty on resales by affiliates which have bought gas in the lease area or at a market hub, so long as the sale from the producer to the affiliate was made at a fair price.[276]

Finally, the common practice of pooling royalty, paying royalty on the weighted average sales price for the royalty pool, ought not be necessary, except in cases where transportation to the sales hub is subject to constrictions that inflate transportation costs or where an inefficient hub market artificially deflates the spot market price. Where the market is not at the well, the lessee has no implied obligation to create one. Where an entrepreneurial lessee creates a market, the lessor's royalty need not reflect the marginal benefits of the lessee's entrepreneurial activity. Instead, a royalty based upon the hub index price, adjusted back to value or amount received at the well, should suffice.[277]

VI. CONCLUSION

Whether the scope of the royalty obligation extends to royalty on take-or-pay benefits and other attributes of the new gas markets is likely to be determined in part by whether the courts view the royalty clause as a plain terms statement of the agreement of the lessor and lessee or as an inherently ambiguous provision of a cooperative venture that requires they look behind the words of the clause to market realities and the parties' relationship. Jurisdictions applying a "plain terms" analysis defined the royalty obligation broadly in the market value royalty disputes but appear likely to adopt a narrow definition in litigation over take-or-pay benefits and new market revenues. Jurisdictions that view the lease as a cooperative venture, however, defined the royalty obligation narrowly in the market value disputes but may extend the obligation to take-or-pay benefits and receipts generated by the market.

But the analysis ought not be that simple. Appealing, though probably ultimately ineffectual, arguments exist that take-or-pay benefits should be subject to royalty as "amounts realized" even in plain terms jurisdictions. Even stronger arguments suggest that, if the oil and gas lease is a cooperative venture, it is nonetheless limited by history and logic to the production function, so that entrepreneurial activities and the revenues they generate—which may include take-or-pay benefits—are beyond the scope of the royalty obligation.

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276. "Sham" sales, of course, would trigger liability for breach of the implied covenants. One pair of commentators has suggested that transactions between producers and marketing affiliates are likely to be scrutinized harshly by the courts. WRIGHT & SHARPE, *supra* note 24, at 249-50.

277. *See supra* notes 140-43 (discussing Carter v. Exxon Corp., 842 S.W.2d 393 (Tex. App.—Eastland 1992, writ denied)).

Whichever approach a court may choose, jurists have ample "wiggle-room." The case and statutory law in Oklahoma, for example, is different enough from that of Louisiana and Arkansas to justify the Oklahoma Supreme Court's refusal to order royalty on take-or-pay benefits. The royalty on take-or-pay benefits cases, as well as the claims for royalty on some of the "unbundled" payments of the deregulated gas industry, are close calls, and we are likely to see them decided inconsistently as a result of legitimate but diverse analyses and differing convictions of fairness.