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THE MARKET PRICE GAS ROYALTY CLAUSE: LESSEES’ NIGHTMARE OUTSIDE OKLAHOMA—TARA PETROLEUM CORP. V. HUGHEY

by John Scully

Consider the following hypothetical: In 1962 Lessor executes an oil and gas lease providing for a royalty payment of one-eighth of the market price at the wells on gas produced by Lessee. Lessee strikes gas in 1963 and soon thereafter enters into a long-term sales contract with Gas Purchaser who has a pipeline near Lessee’s field. The terms of this contract provide that Gas Purchaser will extend the pipeline into Lessee’s field and pay a purchase price of 6 cents per mcf of gas in return for the exclusive right to purchase all gas produced during the life of the lease. To allow for anticipated normal increases in the market price of gas, the contract contains an escalation clause providing for a 2-cent increase in the purchase price every five years.

In 1981, due to the dramatic increase in demand for gas throughout the country, typical lessee-gas purchaser sales contracts provide for prices ranging from $1.90 to $2.10 per mcf. To satisfy the market price royalty obligation under the 1962 lease, however, Lessee currently pays Lessor one-eighth of the Lessee-Gas Purchaser contract price, which, allowing for the effect of the escalation clause, amounts to one-eighth of 12 cents or 1.5 cents per mcf. Naturally dismayed by the fact that he is receiving the meager sum of 1.5 cents per mcf while neighboring lessors are receiving about 25 cents per mcf of gas produced during the same year, Lessor brings suit.

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1. A royalty is the share of production received by the royalty owner (usually the lessor) as compensation for allowing the lessee/producer to deplete his minerals. Generally, the royalty is computed as a fractional amount of production. See J.M. Huber Corp. v. Denman, 367 F.2d 104, 115 (5th Cir. 1966); Ashabranner, The Oil and Gas Lease Royalty Clause—One-Eighth of What?, 20 ROCKY MTN. MIN. L. INST. 163, 172 (1975).
3. Mcf is an abbreviation meaning thousand cubic feet and is the standard used in the natural gas industry for measuring the volume of gas. H. WILLIAMS & C. MEYERS, OIL AND GAS TERMS 228 (2d ed. 1964).
4. In the 1970s gas prices soared, creating an enormous disparity between sales prices under old and new contracts. From 1972 to the third quarter of 1975, the price of intrastate gas in the free market rose from 20 cents per mcf to more than $2.00 per mcf. See Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 831 (Tex. Civ. App.—Beaumont 1978, writ ref’d n.r.e.); Butler v. Exxon Corp., 559 S.W.2d 410, 412 (Tex. Civ. App.—El Paso 1977, writ ref’d n.r.e.).
against Lessee to recover alleged deficiencies in royalty payments.5 Lessor contends that the term “market price” in the royalty provision of the lease does not mean the price negotiated between Lessee and Gas Purchaser in the sales contract; rather, market price means current market price. Lessee’s contention, however, is that oil and gas leases are negotiated with the understanding that the gas sales contract between the lessee and the gas purchaser will necessarily be long-term; consequently, the term market price means the price at which a willing lessee may enter into a long-term gas sales contract with a willing purchaser.

The issue presented by this hypothetical, whether market price means current market price or sales contract price, has given rise to a substantial amount of litigation recently,6 producing a disparity in holdings among jurisdictions. This Comment examines the varying judicial interpretations of the term “market price” and endorses one as the proper solution. Analysis of this issue necessitates an understanding of the oil and gas lease and the relationship between the mineral interest lessor and the lessee-gas producer, as well as the gas sales contract and the relationship between the lessee and the gas purchaser. Accordingly, this Comment explores the nature of these relationships. Finally, the decided case law is examined, including the recent case of Tara Petroleum Corp. v. Hughey,7 which, in the author’s opinion, reaches the soundest legal and equitable result.

I. OIL AND GAS LEASES AND GAS SALES CONTRACTS

A. The Oil and Gas Lease

The most practical method for a landowner/lessor to profit from oil and gas exploration and development of his property is to grant the lessee a determinable fee simple estate in the minerals by the execution of an oil and gas lease.8 Under these lease agreements, the lessee pays the lessor a royalty,9 usually one-eighth of any production of oil or gas from the leased premises. The lessor benefits from the royalties, while the lessee benefits from the profits on the sale of the products from the wells.

1. The Royalty Clause. The provisions comprising the royalty clause are

5. Assuming the applicability of a four-year statute of limitations for actions on contract, the suit covers the period from 1977 to 1981. TEX. REV. CIV. STAT. ANN. art. 5527 (Vernon 1958).
6. “One of the more active fields of gas litigation currently is what has become known as the market value royalty lawsuits. . . . Cases are pending in both state and federal courts and involve untold millions of dollars.” Erck, Current Major Developments in Federal Natural Gas Legislation and Regulation, SW. LEGAL FOUNDATION 30TH INST. ON OIL & GAS LAW & TAX. 155, 173 (1979).
7. 630 P.2d 1269 (Okla. 1981); see notes 107-21 infra and accompanying text.
8. See Gregg, Analysis of the Usual Oil and Gas Lease Provisions, 5 S. TEX. L.J. 1, 4 (1960).
9. The royalty clause is in essence a hedge against uncertainty. In instances in which parties can determine with certainty the quantity of things that they respectively wish to buy and sell, they might be expected to fix a lump sum or a unit price. In the case of oil and gas, however, the existence of the substance, let alone the quantity, is uncertain. G. HARDY & C. ARNOLD, ROYALTIES AND DIVISION ORDERS 9 (1981).
simple in appearance, but they commonly involve a variety of legal concepts. The typical royalty clause describes the royalty to be paid to the lessor as the result of extraction both of oil and of gas by the lessee. This Comment is concerned only with the second part of the clause, the gas royalty provision.

Gas royalty clauses may be classified into three basic categories: (1) in-kind, (2) proceeds, and (3) market price. An in-kind royalty clause calls for payment of royalty by delivery to the lessor of a stipulated proportionate share of the gas produced. This arrangement provides the lessor with his stipulated share of the production without regard to its value or to the expense involved in preparing it. The lessor, however, must have the facilities to take the royalty gas in kind at the well head. Although the in-kind clause probably is the most equitable means of apportioning the royalty interest, it usually is undesirable for two reasons: (1) unlike oil, gas usually cannot be stored on the surface after extraction from the reservoir, and (2) the lessor usually is not equipped to use or market the gas produced and received as royalty.

A proceeds royalty clause provides that the lessor will receive as royalty a fractional share (usually one-eighth) of the proceeds derived from the sale of the gas by the lessee. The amount of royalty received by a lessor under a proceeds clause, therefore, depends entirely upon the terms of the gas sales contract. "Proceeds" has been defined as the income received

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10. Some royalty clauses provide for a different treatment for the extraction of gas from an oil well by the lessee. See, e.g., Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968). The clause in question provided: "To pay to lessor as royalty for gas produced from any oil well and used by lessee for the manufacture of gasoline, one-eighth of the market value of such gas." Id. at 878.

11. A fourth type of gas royalty clause, rental, guarantees a sum certain that is paid to royalty owners as an agreed rental for gas produced from the lease. This type of clause precludes any compensation in addition to the rental stipulated in the lease. Currently, rental clauses rarely are used because of their inherent inequities. Walker, The Nature of the Property Interests Created by an Oil and Gas Lease in Texas, 10 Texas L. Rev. 291, 296 (1952).

12. R. HEMINGWAY, THE LAW OF OIL AND GAS § 7.4 (1971); H. WILLIAMS & C. MEYERS, supra note 2, §§ 643.1-2. Some clauses use the term market value. R. HEMINGWAY, supra, § 7.4(C). Market value is defined as the price property will bring when offered for sale by one wishing to sell, but not obligated to do so, and when bought by one wishing to buy, but under no necessity of buying. State v. Carpenter, 126 Tex. 604, 618-19, 89 S.W.2d 978, 980 (1936); Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829, 830 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.). Although some courts distinguish between the terms market price and market value, the terms are synonymous for purposes of this Comment. See J.M. Huber Corp. v. Denman, 367 F.2d 104, 107 n.5 (5th Cir. 1966); 3 H. WILLIAMS, OIL AND GAS LAW § 650.2, at 648 (1981); Comment, Value of Lessor’s Share of Production Where Gas Only Is Produced, 25 Texas L. Rev. 641, 652-54 (1947).

13. R. HEMINGWAY, supra note 12, § 7.1, at 303-05. For an example of an in-kind royalty clause, see Phillips Petroleum Co. v. Ham, 228 F.2d 217, 218 n.4 (5th Cir. 1956).


16. G. HARDY & C. ARNOLD, supra note 9, at 319.

17. R. HEMINGWAY, supra note 12, § 7.4(D); see Upham v. Ladd, 128 Tex. 14, 15-16, 95 S.W.2d 365, 365 (1936), for an example of a proceeds clause.
from the sale of the gas. The term, however, is nearly as ambiguous as market price; whether it refers to gross or to net proceeds is unclear.

Unlike a proceeds clause, use of a market price royalty clause obligates the lessee to pay the lessor some specified fractional portion (usually one-eighth) of the market price of the gas sold. As illustrated by the hypothetical above, the market price royalty clause is fraught with ambiguity and has become the subject of much litigation. If the court construes the market price provision to be equivalent to current market price, then the court must further address the issue of determining current market price. Discussion of this issue is beyond the scope of this Comment.

2. The Implied Covenant to Market Diligently. If, as a result of exploratory operations, oil or gas is discovered on the leased premises, the interest of the lessee in obtaining a return on his investment usually will lead him to market the product. For various reasons, however, this interest is not always sufficient to impel the lessee to market. When the lessee has as much production from adjoining leaseholds as can be marketed profitably, he may wish to retain control of the leased premises simply to assure capitalization upon any drainage that might occur. The lessee may wish to drill deeper, hoping to find oil rather than gas. Finally, the projected in-

19. R. Hemingway, supra note 12, § 7.4(D). Hemingway suggests that under a proceeds clause, royalty will usually be paid on the sales price less the cost of marketing, transportation, and treatment. Id. at 320-21. But see Ladd v. Upham, 58 S.W.2d 1037, 1039 (Tex. Civ. App.—Fort Worth 1933), aff'd, 128 Tex. 14, 95 S.W.2d 365 (1936) (proceeds means gross receipts without deduction of expenses). Williams and Meyers maintain that the market price controversy can be avoided by including a clause such as the following in the oil and gas lease:

The Lessee shall pay the Lessor a cash royalty of twelve and one-half (12½%) percent of the proceeds realized by the Lessee from the sale of leased substances. . . .

The Lessee shall have the sole and unfettered right to sell or refrain from selling the leased substances, and, in the case of a sale, the Lessee shall have the sole discretion as to the terms and duration of any contract of sale provided always that such contract is fair and reasonable at the time and in the circumstances existing when it was entered into.

H. Williams & C. Meyers, supra note 2, § 650.4, at 380 (ellipsis in original; emphasis added). This is, in fact, the clause many producers employ currently. Discussion with David Butler, legal counsel for Union Oil Co., Gulf Region, in Dallas, Texas (Oct. 21, 1981). The clause, however, does not define the term proceeds; one fears, therefore, that the gross proceeds/net proceeds ambiguity could produce as much litigation as the market price ambiguity has engendered.

21. See notes 1-5 supra and accompanying text.
23. Drainage is the migration of oil or gas in a reservoir attributed to a pressure reduction. It is caused by production from wells bottomed in the reservoir. H. Williams & C. Meyers, supra note 3, at 111.
vestment return may not justify the expense necessary to establish market-
ing facilities.

To insure that the lessor receives his anticipated royalty interest and to
prevent the lessee from taking unjustified advantage of his position, the
courts have created in the oil and gas lease an implied covenant to use
diligence to market the product. Compliance with this covenant has
proved to be especially difficult for lessees and left them in a precarious
position because, until recently, gas was not considered to be a valuable
resource. Once the lessee brought in a gas well, he frequently had to
contract with gas purchasers on terms unfavorable to him to avoid being
sued for failure to market diligently. Specifically, the lessee was forced
to choose between contracting long-term on the purchasers' terms or fac-
ing liability to the lessor for refusing to sell. An understanding of the cir-
cumstances surrounding the execution of gas sales contracts throughout
the history of the gas industry reveals the reasons for gas purchasers' insis-
tence on these long-term contracts.

B. The Gas Sales Contract

Unlike gas, oil is a readily marketable mineral. After extraction from
the reservoir, oil may be stored in tanks on the lease until a quantity suffi-
cient to justify transporting the oil to a market has accumulated. Even
before tanks are constructed on the leased premises, the lessee may move
the oil to market by truck. Gas, on the other hand, cannot be produced
and marketed unless pipelines are available to transport it from the point
of extraction to the point of consumption. Consequently, in the early days
of the gas industry, producers considered gas a waste product and flared it
at the well. After World War II, however, the dormancy of oil pipelines
made transporting large quantities of gas feasible from gas producing re-
gions to demand areas of the country such as the northeast and midwest.
Gas companies began laying pipelines and extensions, and the system soon
grew to establish itself as the sophisticated pipeline system of today.

24. H. WILLIAMS & C. MEYERS, supra note 2, §§ 853-858; Martin, A Modern Look at
Implied Covenants to Explore, Develop, and Market Under Mineral Leases, SW. LEGAL
FOUNDATION 27TH INST. ON OIL & GAS LAW & TAX. 177, 190-93 (1976). Martin notes that
the lessee has the additional duty to obtain the best possible price for the gas. Id. at 191. See
also Annot., 71 A.L.R.2d 1219 (1960).
25. See notes 28-32 infra and accompanying text.
26. Id.
27. Id.
28. In the early days of the oil industry in [Texas], natural gas was regarded
more as a waste by-product of oil production than as a valuable resource. The
gas produced along with oil was often simply burned or “flared”. . . . From
the air, West Texas was said to look as if campfires of all . . . of the armies in
the history of the world were burning below.
Exxon Corp. v. Middleton, 571 S.W.2d 349, 352 (Tex. Civ. App.—Houston [14th Dist.]
11, § 7.1.
30. Id.; Comment, Determination of Fair Market Value for Ad Valorem Tax Purposes of
Pipeline systems, however, are very expensive to build. Before constructing such a transport system, gas purchasers require assurance of large, long-term quantities of gas. From the beginning of the gas industry, therefore, lessee-producers were confronted with a fundamental reality: long-term gas sales contracts.

Lessee-producers reacted to the emphasis on long-term sales contracts through price negotiations. All contracts fix an initial purchase price for the product or at least contain a method for determining an initial price. In addition, the producers and purchasers have developed a variety of price escalation clauses. The most common price adjustment method is the "fixed step-up" provision. This clause obligates the purchasers to pay periodic price increases. For example, such a clause might require an increase of 2 cents per mcf every five years. A "most favored-nation" clause describes an agreement between two parties in which one agrees to extend price terms to the other party equivalent to the terms it extends to its most favored customer. The clause may be either a two-party favored-nation clause or a third-party favored-nation clause. In a two-party clause, the purchaser is obligated to pay the producer a gas price equal to the price it pays any other producer within a specified area. A third-party clause obligates the purchaser to pay the producer a price equal to the price that any other purchaser pays for gas within a specified area. A "BTU" clause permits upward or downward adjustments to the price paid for gas that correspond to fluctuations in the

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32. See Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966); Comment, supra note 30, at 121. In addition to the necessity of a substantial financial commitment by the pipeline company and the lack of gas storage facilities, irrevocable dedication of gas sold in interstate commerce provides a third reason for long-term sales contracts. California v. Southland Royalty Co., 436 U.S. 519, 521-22 (1978).
33. The producer was and still is placed in an extremely difficult position. Faced with rising costs, a long-term inflationary trend in the national economy, and an increasing difficulty in finding new reserves on the one hand, and the requirement that he sell his gas on a long-term basis... under a contract which is subject to abrogation by the regulatory process, he has done the only thing which he could do and devised safeguards for his property through the price provisions of his contracts.
34. Richardson, Negotiating and Drafting Gas Purchase Contracts on Behalf of the Seller, SW. LEGAL FOUNDATION 13TH INST. ON OIL & GAS LAW & TAX. 87, 127 (1962). One commentator observed that, "[t]he real meat in the gas sales coconut, and the most fruitful sources of controversy, are found, of course, in the pricing provisions." Richardson, Producer Contracts for Sale of Natural Gas in Interstate Commerce, SW. LEGAL FOUNDATION 11TH INST. ON OIL & GAS LAW & TAX. 201, 223 (1960).
35. Id.
36. Id.
37. Gregg, supra note 33, at 133.
38. Id.
39. Id.
40. "BTU" is an acronym for British thermal unit and means the amount of heat
heating capacity of the gas supplied. Some producers use a "commodity price index" clause, which allows for price adjustments in accordance with the movement of commodity prices in a specified index. A final means for assuring price flexibility is the price redetermination clause. Under a redetermination clause, the price may be renegotiated at stated intervals. Such clauses commonly include provisions for arbitration in the event that the parties fail to reach agreement on a new price.

The practicalities of marketing gas and the lessee's burden to market diligently have been complicated by the tremendous and unparalleled increase in the price of gas during the past decade. Ambiguous royalty clauses and the absence of effective price escalation provisions have presented the courts with the task of determining whether market price should be interpreted as meaning gas sales contract price or current market price. The courts' responses have been conflicting and generally have produced unfair results.

II. Case Law

A. Fifth Circuit

The reported litigation interpreting the term "market price" has its genesis in two Fifth Circuit cases. In Foster v. Atlantic Refining Co. the lessor executed an oil and gas lease in 1944 to Atlantic Refining Company. The royalty clause provided in part as follows:

The conventional royalties to be paid by Lessee are: (a) On oil and gas, including all hydro-carbons, one-eighth (1/8th) of that produced and saved from said land, the same to be delivered to the credit of the Lessor into the pipe line and to be sold at the market price therefor prevailing for the field where produced when run; . . .

In 1950 the lessee entered into a twenty-year gas sales contract with a local purchaser. The contract provided that the prices per mcf for gas purchased would be approximately 7 cents during the first five-year period, 8.5 cents during the next five-year period, and 9.5 cents during the third five-year period. The contract further provided that during the final five-year period the price per mcf was to be the "fair and reasonable value" of gas being sold in the general area of the leasehold, but in no event was the price to be less than 10 cents per mcf during the period. The lessors filed suit in 1961, asserting that the lessee's royalty payments

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needed to raise the temperature of one pound of water one degree Fahrenheit. H. Williams & C. Meyers, supra note 3, at 37.
41. Gregg, supra note 33, at 136-37.
42. Id. at 135-36.
43. Id. at 135.
44. Id.
45. J.M. Huber Corp. v. Denman, 367 F.2d 104 (5th Cir. 1966); Foster v. Atlantic Ref. Co., 329 F.2d 485 (5th Cir. 1964).
46. 329 F.2d 485 (5th Cir. 1964).
47. Id. at 488.
48. Id.
based on the gas sales contract prices did not comply with the lease requirement to pay the lessor the "market price . . . prevailing for the field where produced when run." The trial court agreed with the lessors' contention and awarded them the difference between what the lessors actually received and what they should have received based on market prices prevailing at the time of delivery.

Although the Fifth Circuit Court of Appeals recognized that the nature of the gas industry requires long-term sales contracts, the court affirmed the trial court's decision because the contract clearly obligated the lessee to pay royalties at the market price prevailing at the time of delivery.

The royalty clause in Foster is unique because it expressly states that market price of the gas is to be determined "when run." Given this addition to the typical market price provision, the court's decision is understandable.

The Fifth Circuit confronted another market price royalty clause in J.M. Huber Corp. v. Denman. Although the royalty clause in Denman did not contain the additional "when run" language of Foster, the court none-

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49. Id.
50. Id.
51. Id. The court also recognized that when the lessee made the gas sales contract in 1950, it received a higher initial price and a substantially higher daily volume sale of gas than could have been negotiated with the other two pipeline companies operating in the area. Id.
52. Id. at 489. The court noted:
   The obligation of [the lessee] to pay royalties is fixed and unambiguous . . .

   When it made the gas sales contract, [the lessee] took the calculated risk of that contract producing royalties satisfactory to the lease terms. The fact that increases in market prices have made the lease obligations financially burdensome is no defense.

53. See text accompanying note 47 supra.
54. But Ashabranner makes the following observation:
   Whether, as a practical matter, [the lessee] knew of the peculiar provisions of this particular lease is questionable. In the day-to-day transactions of a major oil and gas company, many such gas sales contracts are under consideration and many leases are committed to such contracts. While a careful perusal of each lease as to its royalty clause requirements is a legal necessity, it may not always be done due to the volume of work flowing over a particular desk. This is no excuse as a matter of law but is certainly understandable.

55. The Foster decision has been criticized as "severely limit[ing] the business judgment of the lessee and discourag[ing] the making of long-term sales contracts promptly after discovery of gas." 5 H. Williams & C. Meyers, Oil and Gas Law, § 856.3, at 410 n.4.1 (1981).
56. 367 F.2d 104 (5th Cir. 1966).
57. The Denman royalty clause provided:
theless held in favor of the lessors.\textsuperscript{58} In \textit{Denman} the lessors and lessee began negotiating for an oil and gas lease in 1936. Apparently concerned about whether the lessee would promptly market any gas discovered, the lessor insisted that the lessee first obtain a gas sales contract with a pipeline company. Accordingly, the lessee entered into a life of the lease contract with a gas company even though a lease had not been executed. More than a month later, the lessor and the lessee executed an oil and gas lease that specifically referred to the gas sales contract.\textsuperscript{59} The gas sales contract provided for a gas purchase price of $3\frac{1}{2}$ cents per mcf until December 26, 1945, and 4 cents per mcf thereafter for the life of the lease. In 1961 the lessee and the gas company renegotiated the price at 11 cents per mcf.

The lessors brought suit, alleging that the contract prices of 4 cents per mcf paid until 1961, and 11 cents per mcf paid thereafter, failed to satisfy the lessee's royalty obligation to pay the lessor the market price of gas.\textsuperscript{60} The lessee, however, claimed that the gas contract price was the market price.\textsuperscript{61} As in \textit{Foster}, the trial court found for the lessors,\textsuperscript{62} and the court of appeals affirmed that decision\textsuperscript{63} based on a finding that the lessee and lessors had not agreed to calculate royalties on the proceeds received by the lessee under the gas sales contract.\textsuperscript{64}

In \textit{Denman} the lessors had demanded that the lessee obtain a gas sales contract before executing an oil and gas lease.\textsuperscript{65} From the outset, however,

\begin{quote}
To pay the Lessors monthly for one-fourth ($\frac{1}{4}$) of the gas produced at the mouth of the well from any gas well, where gas only is found, four cents per one thousand cubic feet for the first ten years of this contract, and thereafter, the market price of such gas, but in no event shall the price be computed at
less than four cents per thousand cubic feet.
\end{quote}

\textit{Id.} at 107 n.4.
\textsuperscript{58} \textit{Id.} at 121.
\textsuperscript{59} The lease stated that a "true and correct copy of [the] gas sales contract" had been furnished the lessor. \textit{Id.} at 108 n.9.
\textsuperscript{60} \textit{Id.} at 107.
\textsuperscript{61} \textit{Id.} at 109.
\textsuperscript{62} \textit{Id.} at 121.
\textsuperscript{63} \textit{Id.}
\textsuperscript{64} \textit{Id.} at 109. The court stated:

\begin{quote}
We do not minimize the beguiling appeal of the Lessee-Producer's theory. Without a doubt, with the Lessors' full approval, this [sales contract] committed until the exhaustion of the reserves all of the gas to this contract and hence to this "market." But the "market" as the descriptive of the buyer or the outlet for the sale is not synonymous with its larger meaning in fixing price or value. For in that situation the law looks not to the particular transaction but the theoretical one between the supposed free seller \textit{v\textsuperscript{a}-v\textsuperscript{a}} the contemporary free buyer dealing freely at arm's length supposedly in relation to property which neither will ever own, buy or sell. It was not, as this theory would make it read, an agreement to pay $\frac{1}{4}$ of the price received from the market on which this gas is sold.
\end{quote}

\textit{Id.} (footnotes omitted).

\textsuperscript{65} At least one commentator has argued that the lessors' demand for a gas sales contract should have been dispositive of a decision for the lessee:

The lessee . . . argued with some logic that the lessor had pushed him into executing the gas sales contract, had examined it, had been furnished a copy of it, and knew that the contract was designed to remain in force for the life of the lease. Thus, the lessor was in essence a participant, if not a signatory on the contract. This contract . . . established the market and the market value
the royalty being paid the lessors under the lease was inconsistent with the price provisions of the gas sales contract. The lessors initially received payment under the fixed royalty clause of 4 cents per mcf instead of 3½ cents per mcf as provided in the gas sales contract. Clearly the parties never intended royalties to be based on the sales contract provisions. The court noted that the construction of a contract by the parties is frequently the best indication of its purpose. The following specific language in the royalty clause further evidenced the parties’ intentions: “‘and thereafter, the market price of such gas, but in no event shall the price be computed at less than four cents per thousand cubic feet.’” If the parties intended the words “market price” to mean “contract price,” the italicized phrase would be meaningless. Due to the maximum contract price of 4 cents, the royalty never could have risen to more than 4 cents per mcf despite the phrase in the royalty clause.

B. Texas Courts

The Texas Supreme Court first addressed the market price issue in 1968 in Texas Oil & Gas Corp. v. Vela. In 1933 the predecessors in title to the Velas entered into an oil and gas lease that provided for payment of ⅛ of the oil in kind, ⅛ of the market value of gas produced from an oil well, and ⅛ of the net proceeds of casinghead gas sold at the wells. The lease further provided for royalty on gas produced from a gas well as follows: “‘pay to lessor, as royalty for gas from each well where gas only is found, while the same is being sold or used off of the premises, one-eighth of the market price at the wells of the amount so sold or used.’” Gas was discovered soon after the execution of the lease. Between 1934 and 1937 the lessees executed gas sales contracts for the life of the lease at an effective price of 2.3 cents per mcf. At this time, however, no pipeline extended to the leased field and no market for gas existed. Consequently, the lessees

of the gas from this particular lease, and the lessor knew it when he executed the lease.

Ashabranner, supra note 1, at 180. The court said, however, that this condition precedent to the contract served the vital purpose of protecting “the Lessors against the possibility of producing gas wells being shut in from lack of a commercial outlet.” 367 F.2d at 110. Protection of lessors from this possibility, though, is precisely the function of the implied covenant to market the gas diligently. See notes 24-27 supra and accompanying text.

66. 367 F.2d at 108-09.
67. Id. at 109.
68. Id. at 107 n.4 (emphasis added).
69. See id. at 109. The court also noted that an earlier draft of the lease, which contained a “net proceeds” clause, had been rejected by the lessors. Id.; see note 57 supra and accompanying text.
70. 429 S.W.2d 866 (Tex. 1968). The facts in Vela presented a matter of first impression in Texas, the issue being one of substantive law. A subsequent federal case admitted the possible inequity of the result in Vela, but noted that federal courts in a diversity action are bound by the substantive law of the state. Placid Oil Co. v. FPC, 483 F.2d 880, 911 (5th Cir. 1973).
71. Casinghead gas is gas produced with oil in oil wells as distinguished from gas produced from a gas well. H. Williams & C. Meyers, supra note 3, at 46.
72. 429 S.W.2d at 868.
“could market their gas only on a 'life of the lease' basis, and the price stipulated is the only price that could be obtained at that time.”

In 1960 greater reserves were discovered in the Lopeno Field, the location of the Vela lease. Other purchasers and producers soon entered into contracts for the sale of gas from other leases at initial prices ranging from 13 cents to 17.24 cents per mcf. Accordingly, in 1964 the Velas filed suit to recover additional royalties. The trial court entered judgment in their favor, finding that 13.047 cents per mcf was the market price of the gas. The appellate court affirmed the trial court's decision, noting that no Texas case had enunciated the proper rule for determining market price of gas sold under a long-term sales contract.

The court, however, did refer to Foster and recognized that a federal court decision is not controlling on interpretation of Texas law. Nevertheless, the court found persuasive the holding in Foster that the terms of a gas sales contract do not change the lessee's obligations under a lease provision requiring royalty payments based on market price. The court adopted the Foster rationale that the royalty owners were not bound by the gas sales contract because they were not parties to the contract.

The Texas Supreme Court affirmed the judgment of the appellate court that contract price is not synonymous with market price. The court reasoned that the lessees could have employed an alternative clause, such as an in-kind or a proceeds clause, but "[i]nstead of doing so . . . they stipulated in plain terms that the lessee would pay one-eighth of the market price . . . . This clearly means the prevailing market price at the time of the sale or use." In Foster the Fifth Circuit found for the lessor where the lease required royalty payments based on the market price of gas prevailing for

73. Id. at 870.
74. Id. at 868. Two overriding royalty owners intervened in the case, asserting that if the Velas were entitled to recover additional royalties, then they also should be so entitled. Although the appellate court held that the overriding royalty owners were equitably estopped for having accepted the benefits from the 2.3 cents contract, the Texas Supreme Court ultimately permitted recovery. Id. at 875-76.
75. The award totaled more than $55,000 for the four-year period. Id. at 868.
77. Id. at 73-74.
78. Id. at 74.
79. Id. at 73-74. Prior to filing suit, Texas Oil & Gas had acquired the working interest in the lease; Delhi-Taylor Pipeline Corp., a wholly owned subsidiary of Texas Oil & Gas, had acquired the rights of the purchaser under the gas purchase contract. Thus, Texas Oil & Gas was selling the gas to itself. The Supreme Court, however, said that the fact that Texas Oil & Gas had made the gas sales contract in good faith was uncontroverted.
80. 429 S.W.2d at 870.
81. Id. (citing Martin v. Amis, 288 S.W. 431, 433 (Tex. Comm'n App. 1926, opinion adopted)). The parties intentionally may have avoided using the term "proceeds" in the lease, as proceeds arguably is more ambiguous than market price. See note 19 supra and accompanying text.
82. See notes 45-55 supra and accompanying text.
the field where produced when run. In *Vela* the lease language did not contain any similar indication of when the market standard should be applied; however, the Texas Supreme Court approved the *Foster* court's reasoning and result. As in *Foster*, the *Vela* decision results in the lessee-producer paying royalties in excess of his own sales proceeds, even though he negotiated the sales price at arm's length and in good faith.

Four justices dissented in *Vela*. They reasoned that because the royalty provision failed to specify when the market price was to be determined, the intention of the parties at the time the lease was entered into must be examined. Noting the lessors' knowledge of the necessity of long-term gas sales contracts, the dissent said that, "when the parties entered into the lease contract they all knew that the term 'market price' necessarily meant the price prevailing for gas on long-term contract as of the time the sale contract should be made." The Texas Supreme Court recently reaffirmed the *Vela* rationale in *Exxon Corp. v. Middleton*. 

Exxon, the lessee, had obtained four mineral leases that had been executed between 1933 and 1935. Sun Oil Company had obtained interests in six mineral leases in the same field as Exxon between 1933 and 1941. The gas produced from this field was sold in the Texas market pursuant to long-term sales contracts. Exxon calculated royalties primarily on the basis of the proceeds received from the sale of gas. Similarly, the royalties paid pursuant to Sun's gas sales were based on the proceeds received by Sun from the sale of the gas.

The gas royalty clauses in the leases were similar. The Exxon clause provided: "[O]n gas ... sold or used off the premises ... the market value at the well of one-eighth of the gas so sold or used ... that on gas
sold at the wells, the royalty shall be one-eighth of the amount realized from such sale." The Middleton royalty owners claimed that Exxon and Sun violated the royalty provisions of the leases by not paying royalty on the basis of "market value at the well." The lessees countered that all of the sales occurred "at the wells," and, therefore, royalties were properly based on the proceeds realized from the sale of the gas, not on the market value of the gas. The lessees argued in the alternative that if the market value standard in fact applied, then market value is to be determined at the time the gas is committed to a long-term contract, not at the time the gas is actually delivered to the purchaser.

The supreme court held that the sales of the gas occurred off the premises, not at the wells; as a result, the amount of the royalty was determinable by reference to the market value of the gas. The court affirmed its holding in Vela that gas subject to a long-term sales contract is sold, and the market value is determined, at each delivery of gas to the purchaser.

The court rejected the lessees' contention that gas is sold under a long-term contract at the time the sales contract becomes effective. Noting that under the gas royalty clause, royalty was not payable until the gas was "produced from [the] land and sold or used off the premises," the court concluded that the date of the formation of the gas sales contracts did not control resolution of the issue because the contracts were entered into long before gas was produced from the leases and production was a prerequisite to the sale or use of the gas. In addition, the court stated that under the royalty clauses gas is deemed to be sold when it is used.

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90. 613 S.W.2d at 249. The parties agreed that royalties on gas "sold at the wells" were based on the amount realized or proceeds. Id. at 242.
91. Id. at 244-45.
92. Id. at 243.
93. Id. at 244-49. The lessee also contended that the market value royalty standard had been replaced by the terms of division orders. Id. at 249-51. In response to this contention, the court noted that division orders are binding on their signatories only so long as the parties act in accordance with the orders' terms. Id. at 250. Accordingly, royalties paid and accepted under division orders satisfied the lessee's royalty obligations for the period covered by the payments. Id. at 250-51. The court concluded, however, that as a matter of law, the filing of the suit automatically revoked the division orders. Id. at 251.
94. Id. at 244.
95. Id.
96. Id. at 244-45.
97. Id. at 245. The court noted:
When Exxon negotiated the gas contracts, it took the risk that the revenue therefrom would be sufficient to satisfy its royalty obligations. That subsequent increases in market value have made these obligations financially burdensome is no reason to compel this Court to disregard the plain and unambiguous terms of the royalty clause and rewrite it to conform to the meaning that Exxon, as drafter of the language, says was intended.

98. 613 S.W.2d at 244 (emphasis by court). Production means the physical extraction of the mineral from the land. Id. (citing Monsanto Co. v. Tyrrell, 537 S.W.2d 135 (Tex. Civ. App.—Houston [14th Dist.] 1976, writ ref'd n.r.e.)).
99. 613 S.W.2d at 244-45.
100. Id. at 244.
101. Id. at 244-45. The court deduced this conclusion from the fact that the words "sold" and "used" are employed in the clause in the same tense. Id.
is not used until it is delivered, the court reasoned that gas is not sold until it is delivered. 102

The Middleton decision appears to have confirmed the fate of lessees who contracted long-term for the sale of gas at a time when gas was not in high demand. Although the strong dissent in Vela offered some hope for lessees, 103 such relief has not been realized in Texas, and the doctrine of stare decisis likely will run its course to favor royalty owners. 104 The resulting hardship is not limited to Texas producers. Three other jurisdictions have addressed the market price issue; 105 two of them, Kansas and Montana, have followed the Texas courts' rationale. 106

III. OKLAHOMA—RELIEF FOR THE LESSEE AT LAST

In Tara Petroleum Corp. v. Hughey 107 the Oklahoma Supreme Court refused to follow the authority of every other jurisdiction that previously had considered the market price issue. 108 The facts of Hughey are complex and therefore require a detailed exposition. In 1973 four lessors executed a lease covering 161 acres in Greer County, Oklahoma, to Tara Petroleum Company. Six months after the execution of the lease Tara assigned the lease to Coy Brown. 109 After drilling a dry hole, 110 Brown assigned the lease to Wilcoy Petroleum Company in February 1976. In that same month, Wilcoy struck gas on the leasehold and immediately executed a

102. Id.

103. One author had noted:
Bad facts make bad law, and perhaps this is what happened in Vela. Hopefully, good facts in other cases yet to come before our appellate courts will assist in making good law. Perhaps when the Supreme Court has occasion to determine the applicability of the Vela decision in these cases now coming before it, the Court will remember and find appropriate the classic language used by our preeminent former Chief Judge Robert Calvert of the Texas Supreme Court, in the case of Landers v. East Texas Salt Water Disposal Co.

... Judge Calvert wrote . . . :
"If such has been the law, from the standpoint of justice it should not have been; if it is the law now, it will not be hereafter. . . ."

104. Discussion with William Flittie, Professor of Law, Southern Methodist University School of Law, at Dallas, Texas (Oct. 12, 1981).


108. Id. at 1272.

109. In this assignment, Tara reserved an overriding royalty of 1/4 of the 3/4 working interest and reserved an option to purchase all gas produced at 31 cents per mcf. Id. Tara did not exercise this option. Id. at 1275 n.21.

110. A dry hole is a "completed well which is not productive of oil and/or gas." H. Williams & C. Meyers, supra note 3, at 122.
two-year gas sales contract with Jarrett Oil Company.\textsuperscript{111} The well began production in March of 1976. Wilcoy terminated the gas sales contract after the initial two-year period. During the duration of the gas sales contract, Jarrett paid Wilcoy 32 cents per mcf in the first year and 33 cents per mcf in the second year. After purchasing the gas from Wilcoy, Jarrett, a middleman, sold it to El Paso Natural Gas Company. Under its contract with El Paso, Jarrett received the ceiling price allowed by the Federal Power Commission. Soon after Jarrett started purchasing gas from Wilcoy, the Federal Power Commission raised the ceiling price. Consequently, Jarrett paid 32 or 33 cents to Wilcoy for the gas but received prices as high as $1.30 per mcf upon resale.

Relying on the market price gas royalty clause in the lease, the lessors sought additional royalty payments on gas sold during the two-year period.\textsuperscript{112} The lessors maintained that the royalties should be governed by the price El Paso paid Jarrett, not by the prices Jarrett paid Wilcoy. The trial court awarded the plaintiff $18,000 for additional royalties; this amount was to be paid by Tara and Jarrett.\textsuperscript{113} Tara and Jarrett appealed the trial court's judgment.\textsuperscript{114}

Noting that under the lessors' theory the producer would pay one-half of its revenues to the lessors as royalty,\textsuperscript{115} the Oklahoma Supreme Court reversed the trial court's judgment stating:

This would not be fair to the producers. We do not believe that the lessors in this case, the original lessee, or the assignee-producers ever contemplated that the lessors' royalty could be half of what the producers received for the gas. The better rule . . . is that when a producer's lease calls for royalty on gas based on the market price at the well and the producer enters into an arm's-length, good faith gas purchase contract with the best price and term available to the producer at the time, that price is the "market price" and will discharge the producer's gas royalty obligation.\textsuperscript{116}

The court reasoned that its interpretation of market price is consistent with

\textsuperscript{111} 630 P.2d at 1271. The contract was to be automatically extended after the initial two-year period, but either party could terminate the contract on its anniversary date upon ninety days' notice. \textit{Id.}

\textsuperscript{112} \textit{Id.} at 1272. The court quoted the clause as reading:

"2nd. To pay lessor for gas of whatsoever nature and kind produced and sold or used off the premises, or used in the manufacture of any products therefrom, one-eighth (\(\frac{1}{8}\)) at the market price at the well for the gas sold, used off the premises, or in the manufacture of products therefrom, said payments to be made monthly. . . ."

\textit{Id.} (emphasis by court).

\textsuperscript{113} \textit{Id.} The other three lessors had dismissed their actions. \textit{Id.}

\textsuperscript{114} \textit{Id.}

\textsuperscript{115} \textit{Id.} at 1273. The producers were receiving 32 cents per mcf during the first year of the contract. Jarrett, the middleman, was receiving $1.28 per mcf by the end of the first year. If the producers were ordered to pay the lessors one-eighth of the price Jarrett was receiving, they would have had to pay the lessors 16 cents per mcf, one-half the producers' revenues. \textit{Id.}

the intention of parties to similar oil and gas leases.117 Furthermore, the court stated that this interpretation is not unfair to the lessors.118 Producers have a vested interest in seeking the highest possible price for gas produced,119 and this interest necessarily works to the advantage of the lessors through the percentage royalty clause.120

The Hughey decision is significant not only because it produces what is arguably a more equitable result,121 but also because the court decided for the lessee despite less favorable facts for the lessee’s position than in any of the other cases. In all of the preceding cases, the lessees argued that the nature of the gas industry compelled long-term gas sales contracting. The ineffectiveness of price escalation clauses in these long-term contracts created the market price controversy, a controversy that was unforeseeable to the parties at the time the leases were executed. In Hughey, however, the lessee did not execute a long-term gas sales contract; rather, he executed a two-year contract after the market price controversy had already surfaced.

IV. Conclusion

With the exception of the Oklahoma Supreme Court in Hughey, every court that has considered the market price issue has interpreted market price to mean current market price at the time of delivery of the gas. This interpretation exposes the lessee-producer operating under a typical market price gas royalty provision to potential hardship. As demand for gas increases, one-eighth of the current market price eventually could exceed the lessee’s receipts from the gas sales contract. The contention that the parties to these gas leases ever intended the lessee to pay an amount in royalty greater than the revenue received from the gas sales seems unwarranted.

For several other reasons the Hughey decision appears to be technically correct as well as more equitable than the other courts’ conclusions. Outside Oklahoma, the courts have failed to give adequate weight to the significance of gas industry customs in determining the intentions of the parties to the gas lease. The realities of the gas industry necessarily have dictated that gas be marketed under long-term sales contracts, and lessors and lessees executed gas leases within this context. Implied covenants in gas leases demand that gas from producing wells be marketed promptly. At the time a lessee and gas purchaser enter into a sales contract, the subject gas effectively is removed from the open market for the duration of the

117. 630 P.2d at 1274.
118. Id.
119. Id.
120. Id. The court said that the lessors carried the burden of proving that the gas purchase contract between Tara and Jarrett was unreasonable at the time executed. Id. Noting the short-term nature of the contract, the inclusion of an escalation clause in the contract, and the fact that the price negotiated was the highest in the field at the time, the court concluded that the lessors had failed to meet their burden. Id.
121. The lessor continues to receive a substantial royalty payment while the lessee is not forced to pay a major portion of the revenue he receives from the gas purchaser.
contract. Lessors generally are aware of the conditions under which lessees must contract for the sale of produced gas, and certainly most are aware of the lessees' implied obligation to market diligently. Furthermore, interpreting market price to mean the price at which gas is committed to a sales contract is not unfair to the lessor, nor does this interpretation create a windfall for the lessee; the lessor continues to receive a substantial royalty while the lessee is restricted to the proceeds from the contract.