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THE MARKET VALUE CONTROVERSY: *EXXON CORP. v. MIDDLETON*

I. INTRODUCTION

Since the dawning of the energy crisis,[1] producers of natural gas sold in interstate and intrastate commerce[2] have been called on with increased frequency to defend themselves against royalty owners alleging payment of insufficient royalties.[3] Generally, a royalty is a payment made to a royalty owner by a producer of oil and gas under the terms set forth by the gas royalty clause within an oil and gas lease. A royalty compensates the royalty owner for relinquishing the right to the oil and gas by entitling him to a share of production.[4] The market value controversy is attributable to the confusion stemming from gas royalty clauses which provide two standards of royalty computation. Royalties may be computed on the basis of the prevailing market value of natural gas sold or computed on the basis of the sales price, or proceeds, of natural gas sold.[5] Market value controversy cases involve disputes concerning producers who have customarily paid royalties computed on a proceeds basis, or on another standard which is less than market value, regardless of the terms of a controlling gas royalty clause.[6] In 1968, in *Texas Oil & Gas Corp. v. Vela*,[7] the Texas Supreme

1. *See* notes 20-22 *infra* and accompanying text.

2. *E.g.*, Kingery v. Continental Oil Co., 626 F.2d 1261, 1262 (5th Cir. 1980) (involving natural gas sold in interstate commerce under a certificate of convenience and necessity from the FERC); Butler v. Exxon Corp., 559 S.W.2d 410, 412 (Tex. Civ. App. 1977, *writ ref. n.r.e.*) (involving natural gas sold solely in unregulated interstate commerce).

3. *E.g.*, Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980); Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977); Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App. 1978), *rev'd in part*, No. B-7979 (Tex. Oct. 1, 1980), *vacated on rehearing, rev'd in part*, No. B-7979 (Tex. Feb. 4, 1981), Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829 (Tex. Civ. App. 1978, *writ ref. n.r.e.*); Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App. 1977, *writ ref. n.r.e.*).

4. 3 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 38.1 (12th rev. ed. 1967).

5. A gas royalty clause may provide for a fixed royalty payment, *id.* § 40.2, or for the delivery of gas in kind. *Id.* § 40.3. It is more common, however, for the gas royalty clause to provide for royalties computed from the value of the gas produced or for royalties to be computed from the sales price of the gas. These two common royalty provisions are often combined. The result is that the royalty will be based upon market value of the gas sold off the premises if there are no sales at the well. Moreover, the result of such a combination is that the royalty will be based upon the sales price, or proceeds, if there are sales at the well, or on the premises. *Id.* § 40.4. See note 68 *infra* and accompanying text for an example of such a combination of gas royalty provisions.

6. Throughout the history of the industry a 'custom and usage' had developed under which the royalty owners were compensated by payment of a designated percentage of

Court decided that royalty payments would be computed from the prevailing market value of those natural gas sales which were comparable to the particular gas sale which was the subject of the market value controversy in *Vela*.[8] Suing for the difference between royalties computed from the prevailing market value, or market value royalties, and royalties computed from the sales price, or proceeds royalties, is not the only recourse a royalty owner has against a producer.[9] However, it has been the royalty owners' most popular response to the *Vela* decision.

Exxon Corp. v. Middleton,[10] presented the supreme court with another opportunity to consider the market value controversy.[11] Among its pronouncements,[12] the supreme court in *Middleton* held that the

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the 'proceeds' of the sale of gas . . . . This so-called 'custom and usage' largely ignored the exact language of the oil and gas leases and their gas royalty provisions.

Exxon Corp. v. Middleton, 571 S.W.2d 349, 353 (Tex. Civ. App. 1978), *rev'd in part*, No. B-7979 (Tex. Oct. 1, 1980), *vacated on rehearing*, *rev'd in part*, No. B-7979 (Tex. Feb. 4, 1981).

7. 429 S.W.2d 866 (Tex. 1968). *See* note 55 *infra* and accompanying text.

8. *Id.* at 872-74.

9. Amoco Prod. Co. v. First Baptist Church, 579 S.W.2d 280, 287 (Tex. Civ. App. 1979, *writ pending*) (where lessee under a proceeds royalty provision sold gas under a long-term contract, which contained a sales price at approximately one-half of the market value but no price redetermination clause, there was a breach of the implied covenant to market).

10. 571 S.W.2d 349 (Tex. Civ. App. 1978), *rev'd in part*, No. B-7979 (Tex. Oct. 1, 1980) *vacated on rehearing, rev'd in part*, No. B-7979 (Tex. Feb. 4, 1981).

11. Other avenues of recourse are limited in Texas by a four-year statute of limitation. TEX. REV. CIV. STAT. ANN. art. 5527 (Vernon Cum. Supp. 1980). *See* Kingery v. Continental Oil Co., 626 F.2d 1261, 1262 n.1 (5th Cir. 1980); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 868 (Tex. 1968).

12. The court came to a different conclusion than the civil appeals court and trial court concerning the contractual validity of division orders executed by a producer. Generally, a division order sets forth the interest of each royalty owner for the purposes of payment by the producer. *E.g.*, Butler v. Exxon Corp., 559 S.W.2d 410, 417 (Tex. Civ. App. 1977, *writ ref. n.r.e.*). As concerns the market value controversy, a gas division order between the royalty owner and the producer may affect the gas royalty clause of a lease in two ways. First, the division order may relieve the lessee of his obligations under the royalty clause. Second, where the division order differs from the royalty clause concerning the measurement of quantity, quality, price, or value of the production, the royalty clause is modified by the terms of the division order. H. WILLIAMS, OIL AND GAS LAW § 705 (7th ed. 1980). Gas division orders are not normally revocable since the economics of the gas industry dictate that the purchaser of gas must often incur substantial expenditures in the gathering and processing of gas. *Id.* § 704.4. In *Middleton*, the trial court had held that the producer's division orders were binding until revoked by the royalty owners through the service of petitions concerning *Middleton's* market value controversy case. No. B-7979, slip op. at 19 (Tex., Feb. 4, 1981). The civil appeals court expanded the trial court holding by concluding that the producer's division orders were revoked by service of the pleadings where a statutory presumption of consideration required that the division orders, as contractual obligations, were unilaterally irrevocable. *Id.* at 20. The supreme court reversed both lower courts in holding that the division orders did not amend the controlling gas royalty clause language. No. B-7979 (Tex., Oct. 1, 1980). This holding was vacated on rehearing. The supreme court subsequently followed its earlier decision in Chicago Corp. v. Wall, 293 S.W.2d 844, 847 (Tex. 1956) (division order binding until unilaterally revoked), by holding that the royalty payments made and accepted under the producer's division orders were binding until the unilateral revocation of the division orders by the service of petitions of the royalty owners. No. B-7979, slip op. at 20 (Tex., Feb. 4,

word "sold" within a gas royalty clause referred to the sale of gas at the time gas was delivered under a long-term gas contract, and not at the time the long-term gas contract was executed.[13] The court also held that gas is sold "at the well" only when gas is delivered inside the boundary lines of the leased premises.[14] As in *Vela*, the supreme court in *Middleton* implemented a theoretical free market value definition with a test requiring sales comparable in time, quality and availability to marketing outlets for the purpose of computing market value during the intrastate gas sale in question. *Middleton's* treatment of the comparability test significantly amplified the *Vela* test though. In addition, the supreme court in *Middleton* agreed with the rule in *Vela*, which rejected the averaging of all gas prices for gas sold in the field of production, for the reason that such gas was designated for sale in both intrastate and interstate markets and was found to be "conceptually and legally different."[15] Notably, the supreme court in *Middleton* did not examine the effect the National Gas Policy Act of 1978 might have on the market value controversy issue. The Act was passed after the commencement of litigation in *Middleton*, but well before its ultimate disposition, in an effort to mitigate inflationary forces which exacerbated the market value controversy.[16] The purpose of this casenote is to examine the effect of *Middleton* as it pertains to the major issues involved in the market value controversy. Specifically, the issues addressed are: (1) whether gas is "sold" at the time of delivery or at the execution of the contract; (2) whether gas sold "at the well" is determined by the boundaries of the leased premises or the field of produc-

1981); J.M. Huber Corp. v. Denman, 367 F.2d 104, 110 (5th Cir. 1966) (royalty payments in accordance with precise and definite division orders are binding until withdrawn); Pan American Petro Corp. v. Long, 340 F.2d 212, 223 (5th Cir. 1964) (language of division order binding, whether or not a contract, until revoked); Phillips Petro. Co. v. Williams, 158 F.2d 723, 727 (5th Cir. 1946) (royalty payments accepted under a division order are binding until revoked). The supreme court held that, although damages were established at a definite time, prejudgment interest was not recoverable by the royalty owners because the amount of damages was not definitely determinable due to the mathematical uncertainty of determining the market value of the gas in question before the supreme court's determination of the market value. No. B-7979, slip op. at 21 (Tex., Feb. 4, 1981) Black Lake Pipeline Co. v. Union Constr. Co., 538 S.W.2d 80, 95-96 (Tex. 1976) (contractors, in suit against pipeline company, unable to recover prejudgment interest on extra work performed). The supreme court held that a unitization agreement did not obliterate the lease lines for the purpose of royalty payment. No. B-7979, slip op. at 22-23 (Tex., Feb. 4, 1981).

13. *See* notes 180 & 182 *infra* and accompanying text.

14. *Id.*

15. *See* notes 184-191, *infra* and accompanying text.

16. 15 U.S.C. §§ 3301, 3311-3320, 3331-3333, 3341-3348, 3361-3375, 3391-3394, 3411-3428, 3431-3432 (Supp. III 1979).

tion; (3) what constitutes a comparable sale for the purpose of determining the definition of market value; and (4) what effect the NGA has on the market value controversy.

II. THE LAW PRIOR TO THE TEXAS SUPREME COURT DECISION IN *EXXON CORP. V. MIDDLETON*

A. *The Historical Basis*

Until the 1930's, natural gas had very little economic value to oil and gas producers. As a result, natural gas was often flared as a waste product.[17] Though natural gas eventually became too valuable to waste, the association of the product with low economic returns continued to be reflected in the payment of proceeds royalties by the producers to the royalty owners. This method of royalty computation continued into the energy crisis of the early 1970's. Printed oil and gas leases, drafted by producers, often contained gas royalty clauses which obligated the producers to pay either market value royalties or proceeds royalties depending upon the point of delivery to a gas purchaser. Professor Eugene Kuntz has cited an example of such a market value-proceeds royalty clause. The clause states that: "the royalties to be paid the lessor are . . . on gas the market value at the well of 1/8 of the gas so sold or used, provided that on gas sold at the wells, the royalty shall be 1/8 of the amount realized from such sale . . . ."[18] Producers were aware that market value royalties were computed from the prevailing market value of gas sold.[19] However, it was the customary practice of the producer to compensate royalty owners with proceeds royalties no matter where the gas was delivered. Until the energy crisis, royalty owners quietly acquiesced to this method of computation, since, as a practical matter there was almost no difference between a market value or proceeds standard.[20] Proceeds royalties were generally computed on the basis of the sales price received by producers under long-

17. 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 all [*sic*] of the armies in the history of the world were burning below.

571 S.W.2d at 352.

18. 3 E. KUNTZ, *supra* note 4, § 40.4.

19. *E.g.*, Phillips Petro. Co. v. Johnson, 155 F.2d 185, 188 (5th Cir. 1946); Ladd v. Upham, 58 S.W.2d 1037, 1039 (Tex. Civ. App. 1933), *aff'd*, 95 S.W.2d 365, 366 (Tex. 1936); Walker, *The Nature of the Property Interests Created By an Oil and Gas Lease in Texas*, 10 TEX. L. REV. 291,310 (1932).

20. See note 22 *infra*.

term gas contracts. Producers found it necessary to enter long-term contracts in order to meet inherent financing, construction, and operational costs of producing natural gas.[21] The depletion of energy resources made royalty owners aware that they could receive a greater share of production if the producers paid market value royalties instead of the customary proceeds royalties.[22] Until the spiraling market increases, market value royalties were not insisted upon since price adjustment mechanisms built into the long-term gas contracts were generally sufficient to keep the sales price received by the producers in line with any increase in the market value of natural gas sold.[23]

Implicit in the passage of the Natural Gas Act of 1938 (NGA) was the recognition that natural gas could in fact become a valuable commodity.[24] The NGA was enacted by Congress to protect consumers of interstate gas from exploitive natural gas companies.[25] This change in attitude occurred in the 1930's when various communities began to use substantial quantities of natural gas as a heating fuel. The change became more evident in the 1940's with the building of an interstate pipeline system for use in the war effort. This system provided the basis of today's large and complex interstate pipeline system.[26] Furthermore, the 1954 Supreme Court decision in *Phillips Petroleum Co. v. Wiscon-*

21. The reasons for these long-term contracts were at least two-fold. Firstly, a substantial financial commitment was involved in bringing a pipeline to the producing wells and thence to the user. This cost was coupled with the investment required for dehydration and compression, if necessary to meet pipeline standards. Moreover, plants often stripped the liquid hydrocarbons from the gas to yield a valuable by-product. Naturally, one would not expect to invest in and provide such physical facilities at great expense only to have the supply of gas diverted to a new purchaser. Secondly, gas had to be used as produced until relatively recently. The manufacture and storage of liquified natural gas, and the use of some "storage" capacity in spent reservoirs have had little effect on the fact that gas is normally used as quickly as it is produced. These two economic facts of life led to the almost universal use of long-term gas purchase contracts.

571 S.W.2d at 352. Irrevocable dedication of gas sold in interstate commerce provided a third reason for long-term gas contracts. *See* California v. Southland Royalty Co., 436 U.S. 519, 521-22 (1978). See note 130 *infra* and accompanying text.

22. *E.g.*, Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829 (Tex. Civ. App. 1978, *writ pending*) "Until 1972, the price of natural gas made no dramatic increase and was sold by lessees on long term . . . contracts. In 1972, its price began a rapid escalation from about 20¢ per . . . [Mcf] to over $2.00 per Mcf by the third quarter of 1975". *Id.* at 831.

23. *See* Foster v. Atlantic Ref. Co., 329 F.2d 485, 488-89 (5th Cir. 1964) (escalation clause in a gas purchase contract would have assured the lessees of royalties computed from the market price from the years 1958 to 1962); Butler v. Exxon Corp., 559 S.W.2d 410, 412 (Tex. Civ. App. 1977, *writ ref. n.r.e.*) (one cent price escalation clause failed to keep up with inflation rate).

24. 15 U.S.C. §§ 717-717w (1976).

25. When Congress enacted the NGA it was primarily motivated by a desire "to protect consumers against exploitation at the hands of natural gas companies." Sunray Oil Co. v. FPC, 364 U.S. 137, 147 (1960) (quoting FPC v. Hope Natural Gas Co., 320 U.S. 591, 610 (1944)).

26. 571 S.W.2d at 352-53.

sin[27] held that a gas producer came within the NGA definition of a "natural-gas company."[28] The Supreme Court ruling firmly established that it was unlawful for producers and gas purchasers to contract for a gas sales price higher than a just and reasonable price. Under the NGA, gas sold in interstate commerce had to be irrevocably committed to the interstate market under a certificate of public convenience and necessity.[29] The Federal Power Commission (FPC) set ceiling rates in accordance with the requirements of the NGA in order to enforce the just and reasonable prices mandated by that congressional act.[30] As a result of the energy crisis, intrastate gas, which was not irrevocably committed to the interstate market, began to increase rapidly in market value since it was unfettered by FPC regulations.[31] However, as early as the 1960's, the disparity between royalty computations based on the market value of natural gas and the royalty computations based on the proceeds value under long-term contracts became painfully evident to royalty owners of gas irrevocably committed to interstate commerce.

Two Fifth Circuit cases, *Weymouth v. Colorado Interstate Gas Co.*[32] and *J.M. Huber Corp. v. Denman*,[33] resulted from the disparity evidenced in the 1960's between market value and proceeds. In *Weymouth* and *Huber*, producers of gas which was irrevocably committed to interstate commerce had compensated royalty owners on a proceeds royalties basis. The gas prices were stipulated by long-term contracts and limited by the FPC ceiling rate.[34] Accordingly, proceeds royalties

27. 347 U.S. 672 (1954).

28. *Id.* at 684 (a petroleum company which neither engaged in the interstate transmission of gas, nor affiliated with an interstate pipeline company, nonetheless sold gas to interstate pipeline company and was held to be a "natural-gas company"). *See* 15 U.S.C. § 717a(6) (1976).

29. *See* California v. Southland Royalty Co., 436 U.S. 519, 523-24 (1978); 15 U.S.C. § 717F(b) (1976).

30. 15 U.S.C. § 717(c) (1976); *see* United Gas Improvement Co. v. Continental Oil Co., 381 U.S. 392 (1965) "A regulatory statute such as the Natural Gas Act would be hamstrung if it were tied down to technical concepts of local law." *Id.* at 400.

31. As evidenced by the following statutory language, intrastate gas pricing was not limited under the Natural Gas Act.

> The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption.. . . and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other tansportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

15 U.S.C. § 717(b) (1976), *quoted in* Phillips Petro. Co. v. Wisconsin, 347 U.S. 672, 676 (1954).

32. 367 F.2d 84 (5th Cir. 1966).

33. 367 F.2d 104 (5th Cir. 1966).

34. J.M. Huber Corp. v. Denman, 367 F.2d 104, 108-09 (5th Cir. 1966); Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90 (5th Cir. 1966).

were computed on the basis of that rate. In an effort to avoid paying higher market value royalties demanded by the royalty owners, the producers in *Huber* argued that the market value of natural gas was intended, by the parties to the controlling lease, to be the proceeds as computed under a long-term contract.[35] The Fifth Circuit in *Huber* rejected this argument in the following language:

> We do not minimize the beguiling appeal of the lessee-Producer's theory. Without a doubt, with the Lessor's full approval, this 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 synonomous 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 *vis-a-vis* 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 1/4th of the price received from the market on which this gas is sold. Rather, it was to pay 1/4 of the "market price" or "market value" as the case might be.[36]

However, the *Weymouth* court rejected the royalty owners' argument that a theoretical free market value should be used in computing market value royalties in a regulated market system. The court in *Weymouth* concluded:

> The law must take account of the fallout of *Phillips [Petroleum Co. v. Wisconsin]*. That means that while the inquiry might be: what would a willing seller and buyer pay?, the circumstances of that fictional negotiation must reckon with the nature of this business. It is no sense a "free" market. The usual "free, willing" negotiations contemplate a contract binding on each and enforceable as the bargain made. But this is only partially true for gas sales [in interstate commerce]. . . . So this "free," "willing" buyer is not so "free." Nor is his counterpart, the seller. Nor the commodity. Nor is the business. Nor is the sale. The test in capsulated form is then, what would a willing seller and a willing buyer in a business which subjects them and the commodity to restriction and regulation, including a committment for a long period of time, agree

35. 367 F.2d at 109.

36. *Id.* at 109-10 & n.14 (footnotes omitted) (citing Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84 (5th Cir. 1966)).

> to take and pay with a reasonable expectation that the FPC would approve the price [and price changes] and other terms and then issue the necessary certificate of public convenience and necessity.[37]

The court in *Huber* appeared to associate the meaning of market value with a theoretical free market. *Huber* examined the parties intent at the execution of the controlling lease. The court in *Weymouth*, though, defined the market value on the basis of gas sold in interstate commerce in consideration of the nature of the business.

Uncertain in *Huber* as to any FPC regulatory power over royalties computed from the FPC ceiling rate, the court did not conclusively determine the market value of the interstate gas sales in question. Instead, the Fifth Circuit referred the issue to the FPC.[38] The FPC held that oil and gas royalty provisions constituted sales of gas for resale in interstate commerce subject to FPC regulation under the NGA.[39] The District of Columbia Circuit Court of Appeals reversed the FPC's holding in *Mobil Oil Corp. v. FPC*,[40] concluding that royalty owners did not come within the definition of a "natural-gas company" under the NGA.[41] Therefore, the royalties received by a royalty owner could not be subject to FPC regulation. However, the court in *Mobil Oil* also commented:

> [W]e can certainly visualize the possibility that a court confronted with a contention of entitlement to a market price basis higher than the producer's ceiling would consider it to run counter to the intention of the parties, unless there is something to rebut the *fair presumption* that they contemplated interstate movement and market prices compatible therewith.[42]

The disparity between market value royalties and proceeds royalties was evident not only to royalty owners of gas sold in interstate commerce, but to royalty owners of gas sold in intrastate commerce as well.

37. 367 F.2d at 89, 90. Royalty owners alleged insufficiencies in royalties due under a market value royalty provision on gas sold in the FPC regulated interstate market. Royalty owners specifically argued that transactions by other interstate pipeline companies were not the result of arm's length transactions and were therefore incomparable to the interstate gas sales in question for determining market value. *Id.* at 86-88 (footnote omitted).

38. 367 F.2d at 121.

39. Mobil Oil Corp. v. FPC, 463 F.2d 256, 258 (D.C. Cir. 1971). "[T]he royalty payment provisions of oil and gas leases constitute a sale for resale of natural gas in interstate commerce subject to regulation under the Natural Gas Act." *Id.* (footnote omitted) (citing 42 FPC REP. 164, 174).

40. 463 F.2d 256 (D.C. Cir. 1971).

41. *Id.* at 259.

42. *Id.* at 265 (footnote omitted) (emphasis added) (citing Permian Basin Area Rates Cases, 390 U.S. 747, 793 (1968)).

Regarding the intrastate market, the problem is not as significant though. It arises not through market limitations, but through the failure of price adjustment mechanisms to keep pace with the current market rate. In this context, *Texas Oil and Gas Corp. v. Vela*[43] was decided.

B. *The Case Law*

In *Vela*, the royalty owners alleged a deficiency in gas royalty payments. The deficiency was alleged on the basis of the difference between royalty amounts, for which the express wording of the gas royalty clause provided, and the proceeds royalty amounts the producers actually paid.[44] The 1933 oil and gas lease in *Vela* contained a "market price" gas royalty provision which obligated the producer to "pay the 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."[45] The producers also entered into several long-term gas contracts in the mid-1930's which provided a contract sales price from which the proceeds royalties were computed. The natural gas was sold only in intrastate commerce.[46] The supreme court rejected the producer's argument that the gas was "sold" for the contract sales prices at the time the long-term gas contacts were executed and not at the time of delivery to any later gas purchaser for "market price."[47] The supreme court stated:

> It is clear then that the parties knew how to and did provide for royalties . . . , based upon market price or market value, and based upon the proceeds derived by the lessee from the sale of gas. They 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. The gas which

43. 429 S.W.2d 866 (Tex. 1968).

44. *Id.* at 868.

45. *Id.* Generally, "market price" is synonymous with "market value." *See* J.M. Huber Corp. v. Denman, 367 F.2d 104, 107 & n.5 (5th Cir. 1966); Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1, 5 (1977); Butler v. Exxon corp., 559 S.W.2d 410, 417 n.2 (Tex. Civ. App. 1977, *writ ref. n.r.e.*). *But see* Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409, 410-11 (5th Cir.), *cert. denied*, 323 U.S. 737 (1944) (market price not necessarily the same as market value).

46. 429 S.W.2d at 870. The supreme court did permit the indirect consideration of some FPC regulated gas prices in determining market value. *Id.* at 872.

47. *Id.* at 871.

> was marketed under the long-term contracts in this case was not "being sold" at the time the contracts were made but at the time of the delivery to the purchaser.[48]

However, relying on *Foster v. Atlantic Refining Co.*,[49] the supreme court agreed with the civil appeals court in *Vela* that "the contract price for which the gas was sold by the lessee is not necessarily the market price within the meaning of the lease."[50] The supreme court strictly construed the "market price" gas royalty provision against the drafting party.

The contestants in *Vela* agreed with the position that sales of gas which are "comparable in time, quality and availability to marketing outlets" should determine "market price."[51] The supreme court agreed with the civil appeals court's statement "that the mathematical average of all [gas] prices paid in the field is not a final answer to the difficult problem of determining market price at any particular time."[52] However, the supreme court rejected an argument by the producers that the "market price" of the royalty owner's expert witness was the mathematical average of noncomparable gas sales prices. Applying the comparability test agreed on by the contestants, it appears the supreme court found it persuasive that the royalty owner's expert witness had considered only intrastate gas sales comparable to the gas sales in question. Furthermore, the supreme court found it significant that objections to the basis of an expert's testimony went only to its weight and not its legitimacy.[53] The supreme court affirmed both lower courts by stating that the averaging of comparable sales for the time period involved would be the prevailing market price during the gas sale in question.[54]

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48. *Id.*

> The obligation of [the producer] to pay royalties is fixed and unambiguous. It made the gas sales contract with full knowledge of this obligation and did nothing to protect itself against increases in price. The fact that its purchaser would not agree to pay the market price prevailing at the time of delivery does not destroy the lease obligation . . . .
>
> When it made the gas sales contract, [the producer] 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.

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

49. 329 F.2d 485 (5th Cir. 1964).

50. 429 S.W.2d at 871.

51. *Id.* at 872 ("The question is . . . whether . . . there have been recent, substantial, and comparable sales of like gas . . . from wells in the area whose availability for marketing is reasonably or substantially similar to . . . the gas here involved.") (citing Phillips Petro. Co. v. Bynum, 155 F.2d 196, 198 (5th Cir.), *cert. denied*, 329 U.S. 677 (1946)).

52. 429 S.W.2d at 873.

53. *Id.* at 872.

54. "If the rate of production were constant, that figure would be the average market price for the period." *Id.* at 873.

The supreme court held that a "market price" royalty provision in a gas royalty clause of an oil and gas lease entitled the royalty owner to market value royalties, which were computed from the average of all sales prices of gas within a field of production which were comparable to the gas sales in question.[55] In addition, the term "sold" within the same royalty provision, referred to the time of each gas delivery made by a producer under a long-term gas contract and not the time at which the contract was executed. The dissenting judges in *Vela* emphasized that the parties to the oil and gas lease had intended, at the execution of the long-term gas contract, that the contract price be the market value. The dissent also emphasized that while the lease in *Foster* expressly obligated the producer to pay royalties computed from the market price "when [the gas is] run," the *Vela* lease contained no such express obligation.[56] The dissent did agree though, with the application of *Vela's*

55. *But see* Pierce v. Texas Pac. Oil Co., 547 F.2d 519, 521-22 (10th Cir. 1976) (contract price equals market price); Apache Gas Prods. Corp. v. Oklahoma Tax Comm'n, 509 P.2d 109, 112-13 (Okla. 1973) (gas contract price equals market price unless market price is less than contract price at the execution of contract).

56. Four judges dissented in *Vela*. The dissent agreed with the majority opinion that the sales price in a gas contract was not necessarily the market value of comparable gas sales during the gas sales in question. However, the dissent disagreed with the majority's holding concerning when gas is sold.

> The royalty to be paid for gas presents a most difficult problem because of the nature of the gas sales, and has been the subject of much litigation. The Courts have recognized, and the undisputed evidence in this case confirms, that the practicalities of the gas industry require that gas be sold under long-term contracts because the pipelines must have a committed source of supply sufficient to justify financing, construction and operation. Therefore, the rules of daily sales and daily quotations have no application.

429 S.W.2d at 878-79 (dissenting opinion) (quoting Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68, 73 (Tex. Civ. App. 1966)). The "practicalities of the gas industry require that gas be sold under long-term contracts because the pipelines must have a committed source of supply sufficient to justify financing, construction, and operation." Foster v. Atlantic Ref. Co., 329 F.2d at 488 (citing Gex v. Texas Co., 337 S.W.2d 820, 828 (Tex. Civ. App. 1960, *no writ*) (footnote omitted)). Consequently, believing that the parties at the execution of the oil and gas lease had intended gas to be "sold" at the execution of a long-term gas contract, the dissent stated:

> [W]hen the parties entered into the least 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. They knew it could only be sold at a price to be fixed in the contract for gas to be delivered in the future.

429 S.W.2d at 879 (dissenting opinion) (dissent considered gas to be sold at execution of controlling long term contract).

The dissent emphasized that the phrase "when run" in the *Foster* lease distinguished *Foster* from the *Vela* case. In *Foster*, the relevant part of the royalty clause read:

> The conventional royalties to be paid by Lessee are: (a) On oil and gas, . . . one-eighth . . . of that produced and saved from said land, the same to be delivered to the credit for the Lessor into the pipe line *and to be sold at the market price therefore prevailing for the field where produced when run* . . . .

329 F.2d at 488 (emphasis added). The producer paid royalties computed from the proceeds of gas sales under a long-term gas contract. The purchaser would not agree to pay the prevailing market price. The royalty owners argued that they were entitled to the difference between market

comparability test.[57]

With the disparity between the interstate gas market and the intrastate market exacerbated by the energy crisis, the Supreme Court of Kansas decided *Lightcap v. Mobil Oil Corp*.[58] Unlike *Vela*, where natural gas was only sold in intrastate commerce, in *Lightcap* the producers had dedicated their entire natural gas production to the interstate market system under long-term contracts. These long-term contracts called for a "fair, just and reasonable price" to be re-established periodically.[59] Pursuant to the long-term contracts, a rate increase was established by arbitration but only part of the arbitrated rate increase was approved by the FPC. The royalty owners contended that the arbitrated price was the market value of natural gas sold, as determined by a theoretical free market value. However, the producers argued that because the natural gas was sold in interstate commerce under the gas purchase contracts, that royalties should be computed from the contract sale prices or the FPC ceiling rate.[60] The court in *Lightcap*, however, read *J.M. Huber Corp. v. Denman* to stand for the proposition "that a 'market value' lease on its face calls for payment at the theoretical free market value."[61] Agreeing with the royalty owners, the court concluded that the producers were analyzing the problem backwards[62] and held "that the existence of federal regulation over the rates which a gas producer may receive is no obstacle to the fixing of a higher rate as the

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price royalties and proceeds royalties over a four-year period. The Fifth Circuit agreed with the royalty owners in holding that the express terms of the lease required the producer to pay market price royalties instead of proceeds royalties. *Id.* The dissent in *Vela* construed the royalty clause in *Foster* and stated:

> It will be noted under the royalty provision the [producer] did not even have authority to sell [the royalty owner's] one-eighth . . . interest in the gas until it had been delivered to the credit of the [royalty owner] in the pipeline. The parties in effect contracted against long-term gas sales contracts. We have no such limitation in the lease [in *Vela*]. . . . Under the terms of the [*Vela*] lease the [royalty owner] owns all the gas, and it was contemplated by the parties that it would be sold in the usual and customary manner, that is, under long-term contracts.

429 S.W.2d at 880 (dissenting opinion).

57. 429 S.W.2d at 878 (dissenting opinion) (citing Phillips Petro. Co. v. Bynum, 155 F.2d 196, 210 (5th Cir. 1946)).

58. 221 Kan. 448, 562 P.2d 1 (1977).

59. *Id.* at —, 562 P.2d at 4.

60. *Id.* at —, 562 P.2d at 5.

61. *Id.* at —, 562 P.2d at 6. It was in reference to the language in *Huber*, that the supreme court in *Lightcap* made this statement. See note 35 *supra* and accompanying text.

62. [T]he process begins at the other end. The royalties to be paid are first to be determined under state law, based on the terms of the lease. The royalties so determined then becomes a component cost, to be considered by the FPC in determining the rates it will permit [the producer] to charge.

221 Kan. at —, 562 P.2d at 8.

"market value" of the gas it sells for the purpose of computing royalties."[63] Thus, while the price may be suppressed for marketing purposes, it does not necessarily follow that the price must also be suppressed for royalty computation purposes according to *Lightcap*. Like *Vela*, the royalty owners in *Lightcap* were entitled to market value royalties. However, as a dissenting opinion in *Lightcap* noted, "[t]he majority opinion completely disregards the question of what evidence may be necessary to establish a 'market price.' "[64]

Soon after the decision by the Kansas Supreme Court in *Lightcap*, the Texas Civil Appeals Court decided several important cases.[65] The first decision, *Butler v. Exxon Corp.*,[66] concerned a market value controversy over royalties computed from the sale of intrastate gas. The situation was similar to the one in *Vela*.[67] The controlling gas royalty clause provided that royalties "on gas, . . . sold or used off the premises . . . , [shall be] the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale."[68] The natural gas was delivered to the purchaser approximately one hundred feet off of the leased premises.[69] The civil appeals court found it persuasive that, within the gas royalty clause, the language "at the well" was not limited by any language which required the sale of natural gas to be on the leased premises.[70] Citing the federal district court decision of

63. *Id.*

64. 221 Kan. at —, 562 P.2d at 30. Nonetheless, the ruling in *Lightcap* was favorably cited by the Montana Supreme Court in Montana Power Co. v. Kravik, 586 P.2d 298 (Mont. 1978). Though the gas sales in question were only intrastate sales, the supreme court in *Montana Power* stated that:

> The existence of federal regulation over the rates which a gas producer may receive is no obstacle to the fixing of a higher rate as the market value of the gas it sells for the purpose of computing [royalties] . . . .
>
> . . . .
>
> [Furthermore,] under the type of market price lease here, even an FPC regulated gas company would have to pay royalties based on actual market price of gas, regardless of FPC regulations.

586 P.2d at 301-02 (relying on Lightcap v. Mobil Oil Corp., 221 Kan. 448, —, 562 P.2d 1, 11 (1977) (dictum)).

65. Exxon Corp. v. Middleton, 574 S.W.2d 349 (Tex. Civ. App. 1978), *rev'd in part*, No. B-7979 (Tex. Oct. 1, 1980), *vacated on rehearing*, *rev'd in part*, No. B-7979 (Tex. Feb. 4, 1981); Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829 (Tex. Civ. App. 1978, *writ ref. n.r.e.*); Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App. 1977, *writ ref. n.r.e.*).

66. 559 S.W.2d 410 (Tex. Civ. App. 1977, *writ ref. n.r.e.*).

67. *Id.* at 412.

68. *Id.*

69. *Id.* at 413.

70. *Id.*

Skaggs v. Heard,[71] where a sale was on the leased premises but over three hundred feet from the well, the civil appeals court affirmed the trial court's holding that a sale may occur "at the well" where the gas is delivered in the vicinity of the field of production in which the royalty owner's wells are located.[72] The civil appeals court summarily adopted *Vela's* conclusion that market value means the prevailing market value at the time of sale, or delivery, to the gas purchaser.[73] The civil appeals court also noted the fact that the producer had not offered testimony to rebut the royalty owners' expert testimony to the effect that tri-monthly averaging of the three highest prices in the field of production was determinative of the prevailing market value.[74] This was consistent with *Vela's* comparability test which determined the market value of gas sold during the time period in question. *Butler* expressly disapproved of the trial court's decision that market value should be determined by a volume-weighted average of all gas sold in interstate and intrastate commerce from that market area.[75] On remand to the trial court, the civil appeals court stated that "an actual market in the field [of production] will be practically conclusive evidence of [market] value."[76] Finding no reversible error, the Texas Supreme Court refused review.[77]

In the subsequent civil appeals court decision of *Exxon Corp. v.*

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71. 172 F. Supp. 813, 817 (S.D. Tex. 1959) (gas sale within the boundaries of the leased premises, but 320 feet from the nearest well-head, is sold "at the well").

72. 559 S.W.2d at 416.

73. "Believing that the *Vela* case controls as to this lease provision, we held that market value means the prevailing market value at the time of the sale and sale occurs at the time of delivery to the purchaser." *Id.* The dissent in *Butler* disagreed with the result in *Vela* and stated:

> The majority in *Vela* fails to recognize that the market, in the case of natural gas, is not a market of spot sales or deliveries, but of long term contracts made at the given point in time. The minority opinion, recognizing this, is entitled to close attention in any jurisdiction not committed by precedent to the result reached by the majority in *Vela*.

Id. at 419 (dissenting opinion) (quoting 3A W. SUMMER, THE LAW OF OIL AND GAS § 589 (2d ed. 1958)). The dissent in *Butler* further stated:

> [Professor W.L. Summers] is . . . of the opinion that such gas royalty clauses are fraught with ambiguity and that the ambiguity should be resolved in favor of the lessee as a matter of law. This, because of the fact that gas can only be sold and must be sold by long term contracts as to which prices are almost certain to get out of line with contemporary prices, plus the implied . . . obligation of the lessee to market the gas with dispatch.

559 S.W.2d at 419 (dissenting opinion). The dissent in *Butler* disagreed with the majority in *Butler* as to the ruling in *Vela* that gas is "sold" when delivered.

74. 559 S.W.2d at 417.

75. *Id.* at 415, 417. The majority opinion in *Butler* did not define a volume-weighted average. For the definition provided in the supreme court decision in *Middleton* see note 163 *infra*.

76. *Id.* at 417 n.2.

77. Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App. 1977, *writ ref. n.r.e.*).

Middleton,[78] the royalty owners alleged insufficient royalty payments for gas sold during the early 1970's. The controlling gas royalty clause, which was contained in oil and gas leases executed from 1933 to 1944, provided that royalties "on gas . . . sold or used off the premises . . . [shall be] the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalties shall be one-eighth of the amount realized from such sale . . . ."[79] The natural gas was sold in an intrastate marketing system owned by the producer, Exxon Corporation (Exxon). The gas was delivered by Exxon's gas plant, which was not located on the premises. Depending upon which long-term gas contract the gas was sold under, royalties were computed from Exxon's "field price" and on a proceeds basis.[80] The civil appeals court in *Middleton* first considered when gas is "sold." Exxon argued that natural gas could not be "sold" on a daily basis. This was contrary to the trial courts ruling which construed the sale of gas term in the lease as pertaining to the time of gas delivery under a long-term contract. Exxon argued that the trial courts perception of the problem was erroneous since the gas could only be "sold" pursuant to long-term contracts which contained built-in price adjustment mechanisms.[81] Moreover, Exxon argued that the parties intended at the execution of the controlling lease that gas not be sold on a daily basis. Citing *Foster v. Atlantic Refining Co.*,[82] the civil appeals court recognized the inevitable fact that natural gas had to be committed under long-term sales contracts. However, the civil appeals court upheld the trial court in stating that "just as gas was being 'sold' " in *Vela* when it was deliver to purchasers, so was gas . . . 'sold' when it was delivered by Exxon

78. Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App. 1978), *rev'd in part*, No. B-7979 (Tex. Oct. 1, 1980), *vacated on rehearing, rev'd in part*, No. B-7979 (Tex. Feb. 4, 1981).

79. 571 S.W.2d at 356.

80. *Id.* at 355-56.

> In order to compute its field price, Exxon reviews Purchaser's Monthly Gas Reports (PMG Reports) filed by twenty-six major pipeline purchasers in a marketing area consisting of Texas Railroad Commission (TRC) District 3 and seven adjoining counties. Exxon divides the total price reported as paid for one month in each quarter of the year for the gas currently delivered to those major purchasers in the marketing area by the total volume of the gas delivered. The quotient, according to Exxon, is the volume weighted average price for most of the gas sold in the marketing area approximately two to three months before the time for which Exxon is attempting to set its field price. From that volume weighted average price, Exxon makes projections of what the current volume weighted price is. The projected current volume weighted price is Exxon's field price.

Id. at 356.

81. *Id.* at 356-57.

82. 329 F.2d 485, 488 (5th Cir. 1964).

. . . ."[83]

Pursuant to determining when gas is "sold," the civil appeals court in *Middleton* contradicted *Butler* as to when gas is sold "at the well." The trial court held that gas delivered at Exxon's gas plant was sold "at the well." The civil appeals court in Middleton found it persuasive that Exxon's gas plant was not located on the premises of the royalty owner's leases. The civil appeals court reversed the trial court by concluding that gas delivered off the premises was not gas sold "at the wells."[84]

The *Middleton* court also attempted to determine the prevailing market value during the gas sale in question. The comparability test stated in *Vela* was applied to determine if the trial court had been correct in accepting the testimony of the royalty owners' expert witness' as to the method for determining the prevailing market value.[85] *Vela's* comparability test was utilized as a limiting device in examining whether the expert had considered only comparable sales in determining prevailing market value.[86] *Middleton* considered the expert's marketing area from which comparable sales had been drawn. The civil appeals court reversed the trial court ruling that the field of production was the marketing area from which comparable sales would be drawn for determining the prevailing market value. The trial court had

83. "The supreme court's construction of the words 'being sold' in *Vela* is controlling in this case." 571 S.W.2d at 357.

84. "The court's finding that the gas was sold at the [g]as [p]lant is inconsistent with, and better supported by the evidence than, the finding that the gas was 'sold at the wells.' " *Id.* at 365.

85. "All parties agree that comparable sales of gas are those comparable in time, quantity, quality, and availability of marketing outlets." *Id.* at 359 (citing Phillips Petro. Co. v. Bynum, 155 F.2d 196, 198 (5th Cir. 1946)).

86. 571 S.W.2d at 358-62. The civil appeals court gave the royalty owners' expert's testimony as follows:

> [The expert] did not limit his consideration of sales to the [gas] field. He took as the comparable marketing area for his calculation TRC Districts 2, 3 and 4. These districts comprise a very large part of the gas-producing area of South Texas . . . . He obtained PMG Reports from the State Controller's Office. He reviewed more than 30,000 gas sales transactions that were described in the reports in order to determine prices paid for gas in each transaction. He calculated the market value of gas produced from the [royalty owners'] leases during 1973, 1974 and 1975 by averaging the *three highest prices* paid per million b.t.u.'s of gas in TRC Districts 2, 3 and 4 during the first month of each quarter of those years. [The expert] did not consider in his calculations any sales in which the seller was a transmission company or an affiliate of the purchaser, nor did he consider any sales if the same or similar purchase price did not appear in the PMG Reports for Districts 2, 3 and 4 in the following quarter.

Id. at 357-58 (emphasis in original). The Texas Railroad Commission has divided the state of Texas into twelve districts for the purpose of administering oil and gas regulations. The trial court accepted the area encompassed by TRC districts 2, 3, and 4 as the marketing area from which comparable sales would be drawn. These three TRC districts completely border the Texas Gulf Coast. See 4 RULES AND REGULATIONS OF THE TEXAS RAILROAD COMMISSION: OIL AND GAS A-1 (1980).

agreed with the expert's definition of the marketing area from which comparable sales were drawn as three Texas Railroad Commission (TRC) districts outside the field of production. The trial court had also considered the expert's tri-monthly price data drawn from the three TRC districts. It was held by the civil appeals court that monthly price data drawn from the field of production was more consistent with a time period, as here, involving a rapid escalation of the intrastate market value of gas sold. Ultimately, the civil appeals court reversed the trial court after finding that the gas sales which the royalty owners' expert considered were in conflict with the civil appeals court's interpretation of *Vela's* comparability test.[87]

The *Middleton* court considered the testimony proffered by the royalty owners concerning the mathematical computation of comparable sales within the three TRC districts. *Middleton* interpreted *Vela* to require mathematical averaging of all prices paid in a marketing area and to also require corroboration of this average with comparable sales. The civil appeals court concluded that the expert witness had averaged the three highest prices paid in the three TRC districts. Consequently, the civil appeals court overruled the trial court, deciding that

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

We hold that the method adopted in this case does not meet the requirements outlined by the supreme court in *Vela*. [The royalty owners' expert] did not define the relevant market area as the . . . [f]ield [of production]. He refused to give weight to any contracts for sale of gas from this field. The sales that he considered were not shown to be comparable in time, quality and availability to marketing outlets. He selected only the highest prices paid in TRC Districts 2, 3 and 4 that satisfied his criteria. He made no mathematical average of all prices paid in the field, nor did he seek to corroborate such an average with comparable sales as defined by the supreme court. His consideration of price data compiled on a quarterly, rather than monthly, basis is inconsistent with the time period at issue in the case.

571 S.W.2d at 362. *See* note 45 *supra* and accompanying text. The civil appeals court in *Middleton* noted:

We do not believe that the Texas Courts will apply the principles of *Vela* to federally controlled or regulated interstate gas, since there can be no "market value" or "market price" in a price-regulated environment, although we recognize that the supreme court did permit the consideration in *Vela* of the price of regulated gas sold [in determining market value].

Id. at 362 n.3. The civil appeals court in *Middleton*, in dictum, limited the comparability test in *Vela* to market value controversy cases involving only unregulated intrastate gas sales.

only an averaging of all monthly intrastate gas prices drawn from the field of production would be the market value.[88] *Middleton* also considered Exxon's "field price." The court found that since "field price" was partially computed from interstate gas sales and was also lower than the prevailing market value of gas sold in intrastate commerce, interstate gas sales were not comparable to intrastate gas sales and therefore royalties computed from Exxon's "field price," like proceeds royalties, were not market value royalties and, therefore, did not compensate the royalty owners for their share of production.[89]

Immediately after the decision in *Middleton*, the civil appeals court, in *Exxon Corp. v. Jefferson Land Co., Inc.*,[90] was confronted with a similar issue involving intrastate gas sales. The controlling royalty clause stated that "royalties shall be the market value at the well of one-eighth of the gas so sold or used."[91] Unlike the court in *Middleton*, the court in *Jefferson* accepted tri-monthly price data as comparable for the purpose of determining the prevailing market value. Like *Middleton* though, the *Jefferson* court held, in effect, that an average of all gas prices in the marketing area would determine the prevailing market value for the gas sale in question. But the court in *Jefferson* considered the inclusion of long-term gas contract prices entered into before the energy crisis. Exxon argued that its natural gas was committed to a gas system so that Exxon could meet its long-term gas contracts. Therefore, Exxon argued, prices in long-term gas contracts executed before the energy crisis should be included in an average of all prices in the market area. However, the civil appeals court disagreed on the basis that this gas was not committed to any specific customer, as the gas in question had been committed. The civil appeals court in *Jefferson* held that gas prices on long-term gas contracts entered into before the "energy crisis" would be excluded because such prices would have depressed the prevailing market value for the gas sale in question.[92] Finding no reversible error, the Texas Supreme Court refused review.[93]

Prior to the *Middleton* decision, a similar controversy, also

88. *Id.* at 362. *See* note 87 *supra*.
89. *Id.* at 362-63.
90. 573 S.W.2d 829 (Tex. Civ. App. 1978, *writ pending*).
91. *Id.* at 830.
92. [W]e . . . hold . . . that Exxon's weighted average market price for all gas sold by all producers in the particular area is the proper method of determining the market value of the gas produced after January 1, 1973, *provided* such weighted average does not include the price paid for any gas sold under contract entered into prior to said date.
573 S.W.2d at 831 (emphasis added).
93. Exxon Corp. v. Jefferson Land Co., 573 S.W.2d 829 (Tex. Civ. App. 1978, *writ granted*).

originating in Texas, was decided by a federal district court in *Brent v. Natural Gas Pipeline Co. of America*.[94] In *Brent*, the parties stipulated that the controlling leases, executed in the 1920's, required royalties to be "the market value at the well of one-eighth . . . of the gas produced, . . . saved, and sold or used off the leased premises."[95] The federal district court was faced with the problem of determining the market value of natural gas which had been irrevocably committed to interstate commerce. Although noting that the supreme court in *Vela* had not dealt with gas irrevocably committed to the interstate market, the court in *Brent* accepted *Vela's* comparability test for the purpose of implementing a regulated market value definition for determining market value. This regulated market value definition was set forth by the Fifth Circuit in *Weymouth v. Colorado Interstate Gas Co*.[96] The federal district court considered the experts' opinions for both parties in relation to *Weymouth's* regulated market value definition. The court in *Brent* considered that there were two distinct markets for natural gas, an intrastate market and an interstate market, and that the only price available for determining market value of gas irrevocably committed to interstate commerce was the established FPC area rate. The federal district court also considered the testimony of the royalty owners' expert witnesses who examined sales of intrastate and interstate gas in determining the market value for the gas in question. The royalty owners argued that the expert opinions met *Vela's* comparability test. The royalty owners also argued that the expert opinions met *Weymouth's* regulated market value definition because the parties to the pertinent long-term contracts considered the FPC regulation in determining a contract price. Therefore, the royalty owners asserted, the intent of the parties was that market value be derived from both intrastate and interstate gas sales prices. The federal district court clearly rejected this argument because unregulated sales prices of intrastate gas were used in computing the market value for the interstate gas sale in question.[97]

94. 457 F. Supp. 155 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261, 1262 (5th Cir. 1980).

95. 457 F. Supp. at 158.

96. 367 F.2d 84 (5th Cir. 1966).

97. 367 F.2d 84 (5th Cir. 1966). *Brent* stated that "considering FPC regulations of interstate gas, that under the facts of the instant case only sales of interstate gas are comparable to determine the 'market value' of the gas in question, and that sales of intrastate gas are not comparable to make such a determination." 457 F. Supp. at 160 (relying on Hemus v. Hawkins, 452 F. Supp. 861 (S.D. Tex. 1978)).

> The opinions given by [the royalty owner's] expert witnesses must be rejected for two reasons. First, said opinions take into consideration both sales of intrastate and inter-

The court found that the testimony of the producers' expert witness met *Weymouth's* regulated market value definition.[98] Notably though, the opinion of a second producers' expert was rejected by the court because it called for a volume-weighted average of all interstate and intrastate gas sales prices within a geographical area.[99] The federal court in *Brent* held that "the 'market value' of the gas here in question, based on comparable sales here in the interstate market, is the FPC ceiling rate."[100] The court emphasized, however, that the practical effect of its holding required market value to be equated with proceeds or the FPC ceiling rate.[101] The federal court followed and extended an earlier ruling in *Hemus & Co. v. Hawkins*[102] in which the federal district court determined market value in the regulated interstate gas market by analogy to the determination of market value in eminent domain litiga-

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state gas in determining "market value." Secondly, it was shown that many of the interstate gas sales contracts examined and considered by (the royalty owner's) witnesses reflected prices which were short term or emergency sales prices, small producer prices, prices allowed for newly discovered gas and prices which were rolled back to the FPC rate.

. . . .

In conclusion the court finds that there are two distinct markets for gas in the geographical area where defendant's wells are located, the interstate market and the intrastate market. The gas in this case has been irrevocably dedicated to the former. Therefore, only interstate gas sales in the relevant geographical area, made by producers of the same classification as the defendant and involving gas of the same vintage as the gas in question, are comparable to determine the "market value" of the gas involved in this case.

457 F. Supp. at 160, 162.

98. "In view of this conclusion the court finds that the [producer's expert] first opinion of 'market value' is the only opinion which meets both the *Weymouth* and *Vela* standards, and therefore, is the opinion which correctly states the 'market value' of the gas at issued." *Id.* at 160.

99. The "second opinion [of the producer's expert is] based upon the volume weighted average formula must also be rejected because it is founded upon consideration of both intrastate and interstate sales, and upon contracts which were entered into many years before the periods in question in this case." *Id.* at 160-61.

100. [T]he court concludes that the market value of the gas here in question is for the relevant period, the stipulated FPC area rates . . . .

This conclusion is mandated by the test set forth in *Weymouth* . . . and is supported by the *Hemus* case . . . which is directly in point. Additionally, this result is not precluded by the decisions in *Vela* . . . [or] *J.M. Huber Corp.* . . . .

Id. at 161.

101. This court is not holding that the defendant must pay royalties based solely on the price it receives for the gas, rather the holding is that the "market value" of the gas here in question, based on comparable sales in the interstate market, is the FPC area rate. The court recognizes that in reality the result may be the same, that is, what the [producer] receives for its gas will likely be what the "market value" or FPC area rate is, but this result stems from the fact that the only comparable sales of gas are those made in the interstate market and not from the proposition that [the producer] need only pay royalty based on what it receives.

Id.

102. 452 F. Supp. 861 (S.D. Tex. 1978).

tion.[103]

On appeal to the Fifth Circuit, *Brent* was consolidated with the factually similar case of *Kingery v. Continental Oil Co*.[104] The controlling gas royalty clause provided that the royalties "on gas . . . sold or used off the premises . . . [shall be] the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale."[105] The gas was delivered at a point over three miles from the leased premises pursuant to a long-term gas contract entered into in 1949. The district court had merely concluded that because the gas was delivered off the premises then market value royalties were due the royalty owners.[106] This conclusion was not appealed to the Fifth Circuit. The court had determined the prevailing market value of the interstate gas solely on intrastate sales of comparable gas in the "immediate area." Before the court of appeals, the royalty owners argued that the prevailing market value should be determined from all interstate and intrastate sales of comparable gas in the geographical area from the time period in question. This approach, the royalty owners argued, reflected the theoretical free market standard for determining the prevailing market value. The producers argued that only interstate sales prices should be considered for determining the market value because the natural gas was irrevocably committed to interstate commerce. The Fifth Circuit invoked *Weymouth's* regulated market value definition in

103. [T]he key issue in most controversies relating to the "market value" of real property is: What are the comparable sales? Comparability can be determined only by evidence as to the "highest and best use." Decisions as to the "highest and best use" frequently must depend upon the decisions of regulatory bodies . . . . The undersigned, after consideration of the authorities in this field, simply cannot conclude that there is any comparability between a sale in the intrastate market and a sale in the regulated interestate market. The gas here in question is committed to the interstate market. The key to this Court's decision is that sales in the intrastate market are simply not comparable, and expert testimony predicated entirely upon such sales in not a reliable basis for decision.

. . . .

Before the development of the dramatic disparity between the prices paid in the intrastate market versus the interstate market, the weighted average price method undoubtedly had much validity. . . . [T]his was . . . [the] basic method employed . . . in the *Vela* case. With the development, however, of an enormous disparity between the intrastate market price and the interstate market price, the weighted average method would seem to have no validity. The undersigned concludes that interstate prices are simply not comparable to intrastate prices. The interstate market is not comparable to the intrastate market. Averaging prices which are not comparable, therefore, is not a valid method of determining market value.

Id. at 864-65, 866.

104. 434 F. Supp. 349 (W.D. Tex. 1977), *rev'd*, 626 F.2d 1261, 1262 (5th Cir. 1980).

105. *Id.* at 352.

106. *Id.* at 352-53.

accepting the producer's argument. In distinguishing *Vela*,[107] which only considered intrastate gas sales, the court of appeals cited *Hemus & Co. v. Hawkins*[108] which stated:

> We are of the opinion that where the gas has been irrevocably dedicated to the interstate market, it follows inexorably that the only comparable sales to be used in determining the market value of such gas are sales on the interstate market. It likewise follows that sales on the intrastate market are not comparable in determining the market value of such gas.[109]

Responding to the royalty owners' argument that *J.M. Huber Corp. v. Denman*[110] precluded this conclusion, the Fifth Circuit stated:

> *Huber* is not inconsistent with the results we reach in the present cases because we do not hold that the sales price of the gas in question automatically determines its market value; instead we hold only that the market value of *interstate* gas is to be determined by comparison with the sales of comparable gas on the interstate market. This is so because this gas could not be sold on the intrastate market and thus its value on the market was zero. Since sellers and buyers of gas in interstate commerce cannot lawfully contract for a price above that allowed by federal regulation, prices above that figure are simply not comparable.[111]

Finally, the royalty owners argued that the leases in question were executed before the passage of the NGA and the decision in *Phillips Petroleum Co. v. Wisconsin*.[112] Therefore, the royalty owners asserted, because the parties under the leases never contemplated that the amount of royalties would later be affected by federal regulation, the obligations under the leases could not be changed. Responding to this argument, the Fifth Circuit quoted the Supreme Court in *California v. Southland Royalty Co*.[113] in which it was stated that "[h]aving authorized [the producer] to make interstate sales of gas [the royalty owners] could not have expected those sales to be free from the rules and restrictions that from time to time would cover the interstate market."[114]

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107. Kingery v. Continental Oil Co., 626 F.2d 1261, 1264 (5th Cir. 1980). *Kingery* favorably quoted the language from *Middleton*.

108. 452 F. Supp. 861 (S.D. Tex. 1978). *See* notes 101 & 102 *supra*.

109. 626 F.2d at 1264 (citing Hemus & Co. v. Hawkins, 452 F. Supp. 861 (S.D. Tex. 1978)).

110. 367 F.2d 104 (5th Cir. 1966).

111. 626 F.2d at 1265 (citations omitted) (emphasis in original).

112. 347 U.S. 672 (1954). 626 F.2d at 1265. *See* notes 27 & 28 *supra* and accompanying text.

113. 436 U.S. 519 (1978).

114. *Id.* at 528-29, *quoted in* Kingery v. Continental Oil Co., 626 F.2d 1261, 1265 (5th Cir. 1980) (citation omitted).

The Fifth Circuit Court of Appeals reversed *Kingery* and affirmed *Brent* as to the district court dispositions in the consolidated decision of *Kingery v. Continental Oil Co*.[115]

Shortly before the decision in *Kingery*, a federal district court, in *Domatti v. Exxon Corp.*,[116] also commented on the market value controversy. In *Domatti*, natural gas was irrevocably committed to the federally regulated interstate commerce. The royalty owner sought market value royalties.[117] The producer, Exxon, paid proceeds royalties based on the maximum sales price allowed by the Federal Energy Regulatory Commission (FERC)[118] pursuant to a long-term gas contract. Exxon asserted, in its motion for summary judgment, that the FERC ceiling rate was the prevailing market value of the royalty owner's gas.[119] Specifically, Exxon argued that the "fair presumption" statement in *Mobil Oil Corp. v. FPC* was applicable to the present facts because the lease in question was executed years after *Phillips Petroleum Co. v. Wisconsin*.[120] Exxon also posited the rule in *Brent* which stated that intrastate sales of gas are not comparable to interstate gas sales in question in a market value controversy.[121] The royalty owner argued that the FERC ceiling rate regarding the price of the gas was irrelevant to a determination of the prevailing market value royalties. Moreover, the royalty owner argued, only unregulated intrastate gas prices could be used in determining the prevailing market value for gas irrevocably committed to interstate commerce. Specifically, the royalty owner argued that *Huber* was distinguishable from *Weymouth* because *Huber* established that a market value lease requires, on its face, that market value royalties be determined from a price based upon a theoretical free market.[122] The federal court in *Domatti* replied:

115. 626 F.2d 1261 (5th Cir. 1980).

116. 494 F. Supp. 306 (W.D. La. 1980).

117. Two gas royalty clauses covering different leased premises of the royalty owner controlled. One clause was a market value royalty clause. The other was a market value-proceeds royalty clause. *Id.* at 307.

The royalty owner's case was "based upon the contention that rates determined by the (Federal Energy Regulatory Commission) for interstate gas are 'foreign, irrelevant and immaterial' to a determination of the market value of the gas and that reference to the value of unregulated intrastate gas is required." *Id.*

118. *See* note 34 *infra* and accompanying text.

119. 494 F. Supp. at 307.

120. 347 U.S. 672 (1954). 494 F. Supp. at 307-08.

121. Besides *Brent*, Exxon also cited and relied on *Weymouth* and *Hemus*. 494 F. Supp. at 308-09. Responding to Exxon's reliance on these cases, the court in *Domatti* favorably quoted language from *Weymouth*. See p. 556 *supra*.

122. The royalty owners also argued that Sartor v. United Gas Public Service Co., 84 F.2d 436 (5th Cir. 1936), Arkansas Natural Gas Co. v. Sartor, 78 F.2d 924 (5th Cir. 1935), *cert. denied*, 296

> [The royalty owner] attempts to distinguish *Weymouth* and the test announced therein from *Huber*, but we do not believe that the cases announce different rules that require distinction. . . . [I]t seems to us that what *Huber* says is that the parties in that case intended market value to mean value of the gas on the market; *Weymouth* simply defines what the market is.[123]

Consistent with the conclusion in *Lightcap*,[124] the royalty owner argued that a market value lease requires express inclusion of market value royalty language. The *Domatti* court rejected this argument.

The royalty owner in *Domatti* argued that the 1979 Supreme Court decision in *FERC v. Pennzoil Producing Co.*[125] provided authority for denying Exxon summary judgment. In *Pennzoil*, the Supreme Court made a decision relevant to the market value controversy when it commented on the relationship between royalties paid on interstate and intrastate gas sales. The Court pointed out that the NGA did not deny FERC the authority to give rate relief to interstate producers where escalating costs were based upon an unregulated market price.[126] The Court then held that FERC was free to grant relief only in those situations where a producer's "out of pocket expenses in connection with the operation of a particular well exceeds its revenue from the well under the applicable area price."[127] The royalty owner in *Domatti* argued that

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U.S. 656 (1936), Sartor v. United Gas Public Service Co., 173 So. 103 (La. 1937), Sartor v. United Carbon Co., 163 So. 103 (La. 1935), Wall v. United Gas Public Service Co., 152 So. 561 (La. 1934), required the court in *Domatti* to reject Exxon's motion for summary judgment because gas sales which were comparable to the gas sales in question could only be referred to when there was no evidence as to a theoretical free market value. The court in *Domatti* responded:

> [W]e do not think that these old cases address the issues presented in this case. For one thing, all of these cases are pre-*Phillips [Petroleum Co. v. Wisconsin]*. There was no such thing as regulated, interstate gas at the time these cases were decided. Secondly, these cases were decided at a time when gas was often considered as a waste product, before the extensive use of pipelines for gas transmission. Thus, the practical nature of the gas business compels the conclusion that we need not be automatically bound by these cases.

494 F. Supp. at 310 (footnote omitted). *Accord*, Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 91 n.26 (5th Cir. 1966).

123. 494 F. Supp. at 311. The court in *Domatti* made this statement in reference to the language in *Huber* appearing at p. 556 *supra*.

124. 494 F. Supp. at 310. For the rationale which the royalty owner presented, see note 61 *supra* and accompanying text.

125. 439 U.S. 508 (1979). In *FERC v. Pennzoil*, the producer and gas purchaser appealed an FERC ruling that royalty costs could not be passed on to the consuming public if the royalties were not solely calculated on a just and reasonable rate. The producer and gas purchaser had, prior to the FERC ruling, agreed to increase royalty payments above the royalty payments then being computed from the FERC ceiling rate in an effort to meet the standards of controlling market value royalty clauses.

126. 439 U.S. at 516.

127. *Id.* at 517.

because Exxon equated the market value with the FERC ceiling rate then *Pennzoil* must be ignored because the Court had left open the possibility that the market value might be higher than the FERC ceiling rate. The federal district court in *Domatti* noted though, that the Court had never reached the question of market value determination in *Pennzoil*.[128] Furthermore, the court in *Domatti* emphasized that "just because the FERC has power to grant relief based upon market value leases does not mean . . . that . . . market value is not to be determined by reference to interstate-regulated gas or that market value is more than the price received for regulated gas."[129]

The royalty owner in *Domatti* relied principally on *Vela* and *Lightcap* in attempting to prevent summary judgment for Exxon. The federal district court in *Domatti* distinguished *Vela* on factual basis. Specifically, the court alluded to the *Vela* dissenters' conclusion that the parties in *Vela* had intended that the price of the contract be the market value at the time of executing the long term gas contract.[130] In addition, *Domatti* emphasized, as the *Vela* dissenters had, that *Foster v. Atlantic Refining Co.*[131] involved a royalty provision which expressly obligated the producer to pay royalties "when [the gas is] run."[132] The court in *Domatti* also disagreed with the *Vela* decision insofar as it only considered the market value of intrastate gas.[133] However, the court did find merit in the use of *Vela's* comparability test for the purpose of determining market value.[134] The court in *Domatti* also rejected the royalty owner's reliance on *Lightcap* because, as a dissenter stated in *Lightcap*, "[t]he majority opinion completely disregards the question of

128. The market value issue was not addressed since a determination of market value was comprised when the producer and gas purchaser agreed on a rate higher than the FPC ceiling rate. 494 F. Supp. 311.

129. All that the courts have been saying is that there is a distinction, theoretically, between FERC rates and market value; the elements constituting each are different. The cases hold that the FERC has no authority to fix royalty payments based upon market value; they do not hold that FERC rates are irrelevant in establishing market value.

494 F. Supp. at 312.

130. 494 F. Supp. at 312. See notes 51-57 *supra* and accompanying text.

131. 329 F.2d 485 (5th Cir. 1946), *distinguished* in Domatti v. Exxon Corp., 494 F. Supp. at 312.

132. 494 F. Supp. at 312 & n.6. See note 56 *supra* and accompanying text.

133. "We disagree with *Vela* for another reason. The case simply does not address the problem of how the market value of interstate gas is to be determined." 494 F. Supp. at 312.

134. "*Vela* is not however without some merit. The [supreme] court [in *Vela*] did recognize that it is necessary in determining market value to examine 'sales of gas comparable in time, quality and availability to marketing outlets.' " 494 F. Supp. at 313.

what evidence may be necessary to establish a 'market price.' "[135] The court in *Domatti* applied *Vela's* comparability test, and also relied on *Brent*, in concluding that intrastate sales were not comparable for the purpose of determining the market value of gas irrevocably committed to interstate commerce.[136] However, like *Brent* and *Kingery*, the court in *Domatti* stated:

> We do not hold that the price received under the [purchaser's] contract is the market value of the gas because it was the price received; we hold that the price received is the market value because it is the only price that reflects the market value of [the royalty owner's] interstate gas.[137]

Following the reasoning in *Brent*, the court in *Domatti* granted Exxon's motion for summary judgment.[138]

C. *The Natural Gas Policy Act of 1978*

In the fall of 1978, Congress passed the Natural Gas Policy Act (NGPA).[139] The NGPA ended the dual market system first established by the NGA and later reinforced by *Phillips Petroleum Co. v. Wisconsin*, and placed all gas sales under the regulation of the Federal Energy Regulatory Commission (FERC),[140] successor to the FPC. In the place of the dual market system a national market system was substituted with multiple pricing levels.[141] With certain exceptions, the NGPA did not dramatically change the interstate pricing scheme pursuant to the NGA.[142] However, the NGPA spoke directly to intrastate gas sales under both existing contracts[143] and new intrastate contracts entered

135. 494 F. Supp. at 313 (quoting Lightcap v. Mobil Oil Co., 221 Kan. 448, —, 562 P.2d 1, 30 (1977)). See notes 65-77 *supra* and accompanying text.

136. 494 F. Supp. at 314. Note 97 *supra* and accompanying text.

137. 494 F. Supp. at 314.

138. "[F]ollowing the reasoning of the courts in *Brent* and *Hemus*, we hold that intrastate sales are not comparable for determining the market value of the [royalty owner's] gas. [Exxon's] motion for summary judgment is granted." 494 F. Supp. at 314.

139. 15 U.S.C. §§ 3311-3320, 3331-3333, 3341-3348, 3361-3375, 3391-3394, 3411-3418, 3431-3432 (Supp. III 1979).

140. In 1977, the FPC was abolished and its powers were transferred to the FERC under the Department of Energy Organization Act. 42 U.S.C. §§ 7171, 7172, 7293 (Supp. II 1978).

141. 15 U.S.C. §§ 3312-3319 (Supp. III 1979).

142. *Compare* 15 U.S.C. §§ 3314-3315(a) (Supp. III 1979) *with* 15 U.S.C. §§ 717(c)-717(d) (1976).

For an analysis and overview of the NGPA, see Moody & Garten, *The Natural Gas Policy Act of 1978: Analysis and Overview*, 25 ROCKY MTN. MIN. L. INST. 2-1 (1979).

143. The term "existing contract" means "any contract for the first sale of ntaural [*sic*] gas in effect on November 8, 1978." 15 U.S.C. § 3301(13) (Supp. III 1979). The NGPA places intrastate contracts which come under the definition of an existing contract under a ceiling price. 15 U.S.C. §§ 3315(a)-3315(c) (Supp. III 1979).

into after the enactment of the NGPA.[144] Significantly, the legal differences between interstate gas and intrastate gas, as established by the NGA,[145] were nullified until 1985. In that year, gas which formerly made up the intrastate market will largely be deregulated and once again a dual market system will exist.[146]

III. THE TEXAS SUPREME COURT DECISION IN *EXXON CORP. V. MIDDLETON*

A. *Facts and Proceedings*

In the Texas Supreme Court case of *Exxon Corp. v. Middleton*,[147] the royalty owners to certain natural gas leases, executed during the years of 1933 through 1941, brought lawsuits alleging that insufficient royalties were paid by the producer, Exxon.[148] The natural gas was only sold in intrastate commerce under long-term gas contracts.[149] Royalties were computed on a "field price" basis. Exxon claimed that this "field price" was equivalent to the market value of gas sold in the intrastate market.[150] Within the controlling gas royalty clauses the market value provision provided that "on gas . . . sold or used off the premises . . . [royalties shall be] the market value at the well of one-eighth of the gas so sold or used . . . ."[151] The proceeds provision provided "that on gas sold at the wells the royalties shall be one-eighth

144. New intrastate contracts comes under the definition of "roll-over contracts" which are defined as follows:

> [A]ny contract, entered into on or after November 9, 1978, for the first sale of natural gas that was previously subject to an existing contract which expired at the end of a fixed term [not including any extension thereof taking effect on or after November 9, 1978] specified by the provisions of such existing contract, as such contract was in effect on November 9, 1978, whether or not there is an identity of parties or terms with those of such existing contract [is a rollover contract].

15 U.S.C. § 3301(12) (Supp. III 1979). The NGPA places intrastate contracts which come under the definition of a rollover contract under a ceiling price. 15 U.S.C. §§ 3316(b)-3316(c) (Supp. III 1979).

145. *See* notes 29-34 *supra* and accompanying text.

146. 15 U.S.C. § 3331(a)(3) (Supp. III 1979).

147. 571 S.W.2d 349 (Tex. Civ. App. 1978), *rev'd in part*, No. B-7979 (Tex. Oct. 1, 1980), *vacated on rehearing*, *rev'd in part*, No. B-7979 (Tex. Feb. 4, 1981).

148. No. B-7979, slip op. at 1 (Tex. Feb. 4, 1981). For the purpose of clarity, reference to Exxon may also include reference to Sun Oil Co., the other producer involved in the market value controversy in *Middleton*.

149. The parties stipulated that all of the gas from the leases was sold in intrastate commerce during the years 1973-1975. *Id.*, slip op. at 12.

150. *Id.*, slip op. at 10-11.

151. The two market value provisions which controlled in Middleton, although contained in two separate oil and gas leases, were identical in language. *Id.*, slip op. at 2.

of the amount realized from such sale."[152] Exxon's gas plant was located within the field of production, but outside the boundary lines of the royalty owners' leased premises. During three consecutive years which succeeded the escalation of natural gas prices in the 1970's, natural gas produced from the wells of the royalty owners was delivered by Exxon from its gas plant and royalties were paid on a "field price" basis.[153] Ultimately alerted to the discrepancy between market value royalties and "field price" royalties, the aggrieved royalty owners consolidated their claims in a single lawsuit.[154]

The trial court heard testimony as to what gas sales were comparable to the intrastate gas sales in question for the purpose of determining market value. Testimony offered by the royalty owners expert did not limit comparable sales to the field of production. Instead, the expert defined TRC districts 2, 3 and 4 as the marketing area from which comparable sales could be drawn. The districts effectively comprised the Texas Gulf Coast producing area where gathering and transporting facilities were present, and a majority of gas consumption occurred.[155] The districts were interconnected through a complex intrastate and interstate pipeline system. Many Gulf Coast gas contracts contained price redetermination clauses which used these TRC districts as the area from which to draw comparable sales.[156] The expert reviewed more than 30,000 intrastate gas sales transactions within the three TRC districts.[157] From these sales transactions the expert averaged the three highest prices of gas, adjusted to heating capacity,[158] during the first month of each quarter of a year during the gas sales in question.[159]

152. The two proceeds provisions, in *Middleton*, although contained in two separate oil and gas leases, were substantially similar. The other proceeds provision provided "that on gas *so* sold at the wells the royalties shall be one-eighth of the amount realized from such sale." Thus the difference was merely the insertion of the word so between gas and sold. *Id.* (emphasis added).

153. The natural gas was sweet gas. *Id.*

154. Exxon Corp. v. Middleton, 571 S.W.2d at 354-55.

155. No. B-7979, slip op. at 14 & n.3 (Tex. Feb. 4, 1981).

156. *Id.* slip op. at 14. See note 86 *supra*.

157. In Texas, a gas pipeline purchaser is required each month to file a Purchaser's Monthly Gas Tax Report with the State Comptroller of Public Accounts. These reports, commonly called "Form 60-150's" contain the name of the purchaser and seller; the month and year of each purchase; the lease and county from which the gas was produced; the quality of the gas or whether it is produced from an oil well or gas well; the volume purchased; and the price. The [royalty owner's] expert . . . reviewed over 30,000 of these reports to arrive at an opinion of market value.

Id., slip op. at 11. A Purchaser's Monthly Gas Tax Report is filed for severance tax purposes. Exxon Corp. v. Middleton, 571 S.W.2d at 356 n.2.

158. The heating capacity was measured by British Thermal Units. No. B-7979, slip op. at 14 (Tex. Feb. 4, 1981).

159. "[The royalty owner's expert] arrived at his opinion by taking the arithmetical average of

Significantly, most gas purchasers established initial gas contract sales prices and reestablished gas prices under re-determination clauses by using the highest prices.[160] This practice naturally tended to skew an expert's survey. The royalty owners also noted that after the initial price increases precipitated by the energy shortage, Exxon used another method of computation, which Exxon called the "new vintage gas" concept, for determining the market value of gas discovered and produced after January 1, 1972.[161] The trial court adopted the royalty owners' expert's method for determining market value during the gas sales in question.[162]

The trial court also heard testimony from Exxon's expert witness who testified as to the computation of Exxon's "field price." To compute its "field price" Exxon reviewed reports filed by twenty-six major pipeline purchasers in a marketing area consisting of TRC district 3 and seven adjoining counties. Exxon then totaled the sales transactions for one month in each quarter of a year for gas currently delivered to those twenty-six purchasers. Exxon divided this sum by the total volume of the gas delivered by the twenty-six purchasers to obtain a volume-weighted average price.[163] Both the trial court and the civil appeals court rejected Exxon's "field price" computation method on the grounds that it was tantamount to the prevailing market value during the intrastate gas sale in question.[164]

The civil appeals court in *Middleton* affirmed in part and reversed in part the trial court rulings. The civil appeals court affirmed the trial court's holding that the word "sold" referred to the sale of gas on delivery and not at the time of execution of the controlling long-term gas

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the three highest prices paid from quarter to quarter to any quantity of gas anywhere in the relevant market area." *Id.*, slip op. at 11.

160. *Id.*, slip op. at 15.

161. Exxon treats gas discovered and produced after January 1, 1972, as new vintage gas and computes the royalty of this gas in a manner completely different from its field price . . . . Market value for Exxon's new vintage gas is determined, by Exxon, by taking the arithmetic average of the three highest prices paid by a pipeline for sales over one million cubic feet per day, with adjustments [for heating capacity].

Id., slip op. at 16.

162. *Id.*, slip op. at 12.

163. Exxon's expert . . . testified that Exxon's "field price" was the market value of the gas. Exxon's "field price" for the . . . [f]ield [of production] is computed from sales in TRC #3 plus . . . seven adjoining counties . . . . The field price is calculated by taking the total price paid for one month in each quarter for the gas currently delivered to all major purchasers and dividing it by the total volume of gas delivered.

Id., slip op. at 12. In effect, this was *Middleton's* determination of the volume weighted average.

164. *Id.*, slip op.

contract.[165] The civil appeals court affirmed the trial court's rejection of Exxon's "field price" as a basis from which royalties could be computed because interstate sales were considered.[166] The civil appeals court reversed the trial court in holding that a sale of gas "off the premises" was not a sale "at the well."[167] Finally, the civil appeals court reversed the trial court's acceptance of the royalty owners' expert testimony as to the method for determining the prevailing market value during the intrastate gas sales in question.[168] The Texas Supreme Court granted review.

B. *The Issues and Holdings in Middleton*

The supreme court in *Middleton* first determined whether royalties for gas "sold or used off the premises" should be calculated from market value or proceeds. It was clear that for gas sold "at the well," the royalties were to be calculated from proceeds. It was also clear that "off the premises" meant off the leased premises.[169] The question presented was whether the boundary lines of the leased premises determined whether market value or proceeds royalties were to be paid by Exxon. The supreme court looked to whether gas sold "off the premises" could still be sold "at the wells." The royalty owners argued that the gas royalty clause provided for royalties based on "market value" for all gas sold or used off the leased premises. The royalty owners also argued that the royalty clause provided for royalties based on proceeds for all gas sold "at the wells," or within the leased premises. The royalty owners specifically argued that in the "market value" royalty provisions, the phrase "off the premises" modified both "sold" and "used." Therefore, it was asserted, because the market value royalty provision referred to all gas sales off the premises, then the phrase "sold at the wells" included all sales which occurred "on the premises."[170] Relying largely on *Butler*,[171] Exxon argued that in the "market value" royalty

165. 571 S.W.2d at 357-56. *See* note 83 *supra* and accompanying text.
166. 571 S.W.2d at 362.
167. No. B-7979, slip op. at 3 (Tex. Feb. 4, 1981).
168. 571 S.W.2d at 362.
169. No. B-7979, slip op. at 3-4 (Tex. Feb. 4, 1981).
170. *Id.*, slip op. at 4.
171. Exxon relies heavily on *Butler v. Exxon Corp.* In *Butler*. . . . the royalty clause is almost identical to the one in issue. Gas produced from the *Butler* leases was sold off the leased premises, but within the field of production. The trial court interpreted the phrase "sold at the wells" to include sales which occurred anywhere in the vicinity of the field and found the gas sold from the Butler leases was "sold at the wells." The Court of Civil Appeals expressly approved this finding. It noted the parties did not use mutually exclusive terms such as "on the premises" and "off the

provision, the phrase "off the premises" modified only the word "used" so that the phrase "sold at the wells" could be neither defined nor limited by the language in the lease. Accordingly then, a sale "at the well" could include any sale within the field of production.[172] The supreme court looked to the entire gas royalty clause. The court gave heavy consideration to the fact that Exxon's construction created overlaps between the requirements of the market value royalty provision and the requirements of the proceeds royalty provision.[173] The supreme court also compared the distances from the leased premises in *Skaggs v. Heard*[174] and *Kingery v. Continental Oil Co.*[175] The supreme court affirmed the civil appeals court decision by agreeing with the royalty owners' argument that gas sold "off the premises" means gas which is

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premises" or "at the well" and "away from the well," and that the clauses based on "amount realized" from a sale "at the well" had no limiting language requiring the sale to be "on the premises." The court relied primarily on expert testimony about what constituted a "sale at the well" as understood in the oil and gas industry. *Id.*, slip op. at 6-7. *See* p. 562 *supra* for the royalty clause in *Butler*.

172. No. B-7979, slip op. at 4 (Tex. Feb. 4, 1981).

173. Exxon's contention that the words "off the premises" modifies the word "used" and not the world "sold" is weakened by looking at the entire clause.

> . . . on gas . . . sold or used off the premises
>
> . . . the market value at the well of one-eighth of the gas *so sold* or used.

The words "so sold" imply the gas has been sold in a certain manner. In Webster's Third International Dictionary, "so" is defined as "in a manner or was that is indicated or suggested. If, as Exxon insists, "off the premises" modifies the word "used" only, parallel construction would rewrite the phrase to provide a royalty calculated on "the market value at the well of one-eighth of the gas sold or so used."

Exxon's construction creates royalty standards which overlap. According to Exxon, the market value standard applies to all sales wherever they occur, whereas, the amount realized standard applied only to sales at the wells even though sales at the wells are covered by the market value standard. Exxon's construction would cause the royalty clause to read as follows:

> On gas . . . produced from said land and *sold* . . . the market value at the well of one-eighth of the gas so *sold* provided that on gas *sold* at the wells the royalty shall be one-eighth of the amount realized.

We conclude "off the premises" modifies both "sold" and "used." The "premises" is the land described in the lease agreement. Therefore, sold "off the premises" means gas which is sold outside the leased premises. Thus, "sold at the wells" means sold at the wells within the lease, and not sold at the wells within the fields.

Id., slip op. at 4-5 (emphasis in original)

174. 172 F. Supp. 813 (S.D. Tex. 1959). "In *Skaggs v. Heard* . . . it was held, under a gas royalty clause, that a sale at a separator on the leased premises, but 320 feet from the wellhead, was a sale 'at the well' as opposed to being a sale not at the well and off the leased premises." No. B-7979, slip op. at 7 (Tex. Feb. 4, 1981). *See* note 71 *supra* and accompanying text.

175. 434 F. Supp. 349 (1977), *rev'd on other grounds*, 626 F.2d 1261 (5th Cir. 1980).

> [I]n *Kingery v. Continental Oil Co.* . . . the [c]ourt, in construing a gas royalty provision similar to the one in question, held that a sale off the premises was not a sale at the wells. In that case the point of delivery was located off the premises approximately 3-1/2 miles from nearest line of the leased premises.

No. B-7979, slip op. at 7 (Tex. Feb. 4, 1981). *See* notes 104-09 *supra* and accompanying text.

sold outside the leased premises.[176] Moreover, the supreme court found its conclusion to be consistent with its construction of the language in the *Vela* lease.[177] Significantly, without reference to how far Exxon's gas plant was from the lease premises, the supreme court stated that "[t]o the extent the Civil Appeals' interpretation of the royalty clause in *Butler* . . . conflicts with our interpretation of this [royalty] clause, it is disapproved."[178]

The supreme court in *Middleton* then considered the issue of when and how "market value" should be determined. It was undisputed that "market value" is determined when the gas is sold. The question presented was when the gas was "sold." In an attempt to show that the civil appeals court erred in relying on *Vela*, Exxon argued that *Vela* was distinguishable because, unlike the language in the present royalty provisions, the language in *Vela's* royalty provisions evidenced the parties intent that market value be determined when the gas is delivered to a gas purchaser under a long-term gas contract. The supreme court rejected this argument after construing the term "sold," and several other royalty provision terms, to support the position that the original parties to the lease in *Middleton* also intended "market value" to be determined upon delivery.[179] Exxon also argued that the financial realities of the natural gas industry required that "sold" mean the time gas

176. Note 174 *supra*. *See* note 84 *supra* for language in the civil appeals court in *Middleton* which the supreme court quoted and affirmed. No. B-7979, slip op. at 3 (Tex. Feb. 4, 1981).

177. Our construction in no way conflicts with *Texas Oil and Gas Corporation v. Vela* . . . . In *Vela*, the royalty clause obligated Texas Oil and Gas:

> 'To pay to lessor, as royalty for gas from each well where gas only is found, while the same is being *sold or used off the premises*, one-eighth of the market price at the wells of the amount so sold or used . . . .'
>
> Gas produced from the *Vela* leases was sold on the leased premises. The sole standard for calculating royalties was market value, regardless of where the sale took place. Under those circumstances, the phrase "off the premises" did not modify sold, and the words "so sold" as used in that context referred to all sales.

No. B-7979, slip op. at 5-6 (Tex. Feb. 4, 1981).

178. *Id.*, slip op. at 7.

179. Under the express terms of the clause, 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. The gas purchase contracts became effective *before* the gas was produced and sold. The clause also employs the words 'sold' and 'used' in the same tense. Gas is 'used' when delivered or consumed. The time gas is 'sold' is the same time gas is 'used'—when it is delivered. Because Exxon must pay royalties based on market value for gas 'used off the premises,' that same royalty clause cannot permit Exxon to pay royalties on 'gas sold off the premises' on any basis other than its market value when delivered. The wording of the royalty clause, therefore, negates the idea of the sale of gas on the effective date of a gas contract for royalty purposes. Just as gas was 'being sold' when delivered to the gas purchasers in *Vela*, so was gas 'sold' when delivered by Exxon to its customer.

Id., slip op at 8-9 (citation omitted) (emphasis in original) (citing Monsanto Co. v. Tyrrel, 537

became committed to a long-term gas contract.[180] The supreme court emphasized the distinction between Exxon's royalty obligation under a lease and its obligation under a contract. Relying on *Foster* and *Vela*, the supreme court noted that the burdensome obligation which Exxon had incurred by negotiating gas purchase contracts presented no reason to disregard the plain and unambiguous terms of a lease drafted by Exxon and negotiated independently of the subsequent long-term gas contracts.[181] Furthermore, the supreme court found Exxon's use of two different computations from determining market value, the "field price" computation, and the "new vintage gas" computation, inconsistent with the determination that gas is "sold" when delivered. The supreme court also perceived this practice to be inconsistent with the determination of market value from a comparable sales measurement. On this point, the supreme court emphasized that market value is not dependent on when gas is discovered.[182] In line with its decision in *Vela*, the supreme court strictly construed the terms of the royalty provisions and concluded that market value would be determined when the gas was delivered under a long-term gas contract.

The supreme court then turned to determine how market value is determined. The supreme court first defined "market value" by stating:

> Market value is defined as the price property would bring when it is offered for sale by one who desires, but is not obligated to sell, and is bought by one who is under no necessity

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S.W.2d 135, 137 (Tex. Civ. App. 1976, *writ ref. n.r.e.*)) (term "production," as found in an oil and gas lease in question, meant the actual physical severance of the mineral from the soil).

180. No. B-7979 slip op. at 9 (Tex. Feb. 4, 1981) (emphasis in original) (citation omitted).

181. Exxon insists the practicalities of the natural gas industry require us to construe 'sold' to mean the time the gas becomes committed to a bona fide long-term gas contract. We are not unmindful of the realities of the gas industry; however, our resolution of this problem is based upon the recognition of two separate and distinct transactions, the lease agreement and the gas contract. Although as between Exxon and its customer, the gas may have been sold when the contracts became effective, there is no basis in the royalty clause for applying such a definition to the lease agreements. Exxon's royalty obligations are determined from lease agreements which were executed prior to and wholly independent of the gas contracts. 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 in 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. Exxon's royalty obligations are fixed and unaffected by its gas contracts. If the parties intended royalties to be calculated on the amount realized standard, they could and should have used *only* a 'proceeds-type' clause.

Id., slip op at 9-10. (citations omitted) (emphasis in original). The court in *Middleton* added that "[t]he parties did not use 'market value' and 'amount realized,' interchangeably and we reject Exxon's assertion that the parties intended 'market value' to have essentially the same meaning as "amount realized." *Id.*

182. *Id.*, slip op. at 17.

> of buying it. To determine the market value of gas, the gas should be valued as though it is free and available for sale.[183]

Relying on *Vela*, the supreme court observed that "[m]arket value may be calculated by using comparable sales [which are] sales of gas . . . comparable in time, quality, quantity, and availability to marketing outlets."[184] The supreme court determined that *Vela's* comparability test would be used to implement a theoretical free market value definition. The supreme court then considered what sales were comparable to the intrastate gas sales in question for the purpose of determining the market value during the intrastate gas sales in question.

Middleton considered the civil appeals court's rejection of the expert testimony introduced by the royalty owners' as to the determination of the prevailing market value at the time of the relevant intrastate gas sale. The supreme court also noted the fact that gas production, gas gathering and transporting facilities, and gas consumption were present within the three TRC districts. In addition, the court considered that many Gulf Coast gas contracts contained price re-determination clauses which used these three TRC districts as the relevant market area. The trial court had held that the relevant marketing area, from which comparable sales could be drawn, was the three TRC districts considered by the royalty owners' experts. In reversing the trial court, the civil appeals court had interpreted *Vela* to hold that the relevant marketing area was the field of production. The supreme court, however, emphasized that the relevant marketing area was dependent upon the facts of each market value controversy case. The supreme court held that a marketing area existed when "within this area [there were] sales comparable in time, quality, and availability of marketing outlets"[185] to the gas sale in question.

The supreme court in *Middleton* considered the expert testimony introduced by the royalty owners' regarding which sales were compara-

183. No. B-7979, slip op. at 13 (Tex. Feb. 4, 1981) (citation omitted) (citing Polk County v. Tenneco, Inc., 554 S.W.2d 918, 921 (Tex. 1977)).

184. Sales comparable in time occur when contracts executed contemporaneously with the sale of the gas in question. Sales comparable in quality are those of similar physical properties such as sweet, sour, or casinghead gas. Quality also involves the legal characteristics of the gas; that is, whether it is sold in a regulated or unregulated market, or in one particular category of a regulated market. Sales comparable in quantity are those of similar volumes to the gas in question. To be comparable, the sales must be made from an area with marketing outlets similar to the gas in question. Gas from fields with outlets to interstate markets only, for instance, would not be comparable to gas from field with outlets only to the intrastate market.

No. B-7979, slip op. at 13 (Tex. Feb. 4, 1981) (footnote omitted).

185. *Id.*

ble to the intrastate gas sale in question for the purpose of determining market value during the time involved. From a qualitative perspective, the supreme court agreed with the expert's conclusion that sweet gas sales were comparable.[186] Moreover, the supreme court found that all of the sales transactions had been adjusted according to the gas' heating capacity. Legal quality was also considered. The supreme court found it persuasive that only intrastate gas sales, not interstate gas sales, were considered by the expert.[187] The supreme court also found persuasive the expert's testimony that gas sales need not be quantitatively comparable where the heating capacity of the gas is known. Consequently, the supreme court ignored the element of quantitative comparability.[188] The supreme court accepted the expert's testimony that the three TRC districts were interconnected through a complex intrastate and interstate pipeline system. Consequently, the supreme court agreed with the expert that gas within the three TRC districts was comparable to the gas in question in availability to marketing outlets. Finally, the supreme court agreed with the tri-monthly averaging by the expert of the three highest prices in the three TRC districts since they represented the most current price in a rapidly escalating market. The court also considered it significant that most gas purchasers determined gas contract prices by using the highest gas prices.[189] The supreme court found that the royalty owners' expert's testimony met the theoretical free market value definition as determined by *Vela's* comparability test.

Exxon attempted to discredit the expert testimony proffered by the royalty owners. Exxon argued that the royalty owners' expert had valued the gas as if it were sold on a theoretical free market. Therefore, Exxon argued, because the gas which Exxon sold was committed to long-term contracts, then the expert's sales were incomparable. The supreme court noted though, that a gas contract between Exxon and a third party would not alter Exxon's duties under the lease. The supreme court affirmed the trial court's valuation of the intrastate gas sales in issue as if the gas were sold in a free market.[190] The supreme court also considered the argument that Exxon's "field price" was synonymous with the prevailing market value at the time of the gas sale.

186. *Id.*, slip op. at 14. *See* note 153 *supra*.
187. No. B-7979, slip op. at 15 (Tex. Feb. 4, 1981).
188. "[The royalty owner's expert] testified that if one knew the btu value of the gas and made the necessary adjustments, that sales could be made comparable regardless of quantity." *Id.*
189. *Id.*
190. "We hold that the trial court did not err in valuing the gas as if it were free and available for sale." *Id.*, slip op. at 16.

The supreme court acknowledged that the "field price" was admissible as evidence. But the supreme court concluded that interstate and intrastate gas prices were "conceptually and legally different."[191] The court buttressed this conclusion in emphasizing that Exxon's "new vintage gas" concept was remarkably similar to the royalty owners' expert's method for determining market value.[192]

Finally, the supreme court in *Middleton* considered the civil appeals court's requirement that a mathematical average of all gas prices within a field of production be corroborated with comparable sales. In *Middleton* the supreme court quoted its statement in *Vela* that a mathematical average of all prices paid in the field is "not a final answer to the difficult problem of determining market value at any particular time."[193] *Vela's* holding as to a mathematical average of all gas prices was derived from expert testimony. Cognizant of this fact, the supreme court cited the Fifth Circuit's decision in *Weymouth* in emphasizing:

> The complexity of the oil and gas industry makes it difficult to establish a formula to determine the market value of gas in each field in Texas. The market value of gas may be established by expert testimony. Once experts qualify, their testimony is to be considered by the fact finder. Objections to the basis of their testimony goes to its weight, not to its admissibility.[194]

Middleton held that there was some evidence to support the trial court's acceptance of the royalty owner's method for determining the prevailing market value for the time period in question. The supreme court affirmed both lower courts in holding that the word "sold" within a gas royalty clause referred to the sale of gas at the time gas is delivered under a long-term gas contract, and not at the time the long-term con-

191. *Id.* This was only dictum though, since the gas sale in question was only an intrastate gas sale.

192. In fact, the formula used by Exxon for calculating royalties on new vintage gas is remarkably similar to [the royalty owner's expert's] market value. Market value for Exxon's new vintage gas is determined, by Exxon, by taking the arithmetic average of the three highest prices paid by a pipeline for sales over one millions cubic feet per day. *Id.*, slip op. at 16.

193. *Id.*, slip op. at 17.

194. This view is too restrictive for the situation of an expert witness explaining his opinion. Lessors' heavy reliance on the *Sartor* cases would bind upon us and all experts the rules applicable to introduction of direct evidence of comparable sales. This is simply unrealistic where we deal with an expert who, once he establishes his qualifications and he gives his broad, general opinion, needs to be able to reveal the basis for his opinion in his own language without too many communication-crippling legal barriers thrown in his way. *Id.*, slip op. at 17-18 (quoting Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84, 90-91 (5th Cir. 1966)).

tract is executed. The supreme court affirmed the civil appeals court ruling that gas is sold "at the well" only when it is delivered inside the boundary lines of the leased premises. Similar to the decision in *Vela*, the supreme court in *Middleton* implemented a theoretical free market value definition with a test requiring sales comparable in time, quality and availability to marketing outlets for the purpose of computing market value during the the intrastate gas sale in question. Significantly though, the supreme court in *Middleton* rejected *Vela* insofar as it held an averaging of all gas prices for gas sold in a field and production was required. *Middleton* concluded in dictum that gas sold in intrastate and interstate commerce was conceptually and legally different.

IV. ANALYSIS OF THE MARKET VALUE CONTROVERSY IN *EXXON CORP. V. MIDDLETON*

A. *When Is a Sale "Off the Premises?"*

The supreme court in *Middleton* considered the major issues of the market value controversy pertaining to the sale of intrastate gas, which remains unregulated by the federal government.[195] The supreme court considered the issue of whether Exxon's gas plant could be both "off the premises" and "at the well." In *Vela*, the supreme court explicitly set forth that what a royalty owner received in royalty payments was strictly determined by the language of the controlling gas royalty clause. *Vela*, though, did not consider the question of when gas is sold off the leased premises. The market value-proceeds royalty clause, which has been the source of vigorous litigation in market value controversy cases, distinguishes the payment of market value royalties and proceeds royalties on the basis of the delivery point at which the gas is sold. The producer in *Butler* raised this distinction in successfully arguing that distinguishing the gas royalty phrases "at the well" and "off the premises" on the basis of the boundary lines of the leased premises had no relation to the economic realities of a gas field of production and should not be limited by such boundary lines but by the field of production. Though the distance between Exxon's gas plant and the boundary lines of the leased premises was not considered, the supreme court did note the distances involved in the federal district court decisions in *Skaggs v. Heard* and *Kingery v. Continental Oil Co.*, where boundary lines of the leased premises' were considered to be distinc-

195. *See* note 12 *supra* for mention of the supreme court's conclusions in *Middleton* which are not dealt with in this casenote.

tions, between the terms "at the well" and "off the premises." In interpreting gas royalty clause language almost identical to the language interpreted by the civil appeals court in *Butler*, the *Middleton* court emphasized that the obligation to pay market value royalties and proceeds royalties could not be overlapped. This result would occur if the term "off the premises" were construed to modify only the word "used". The effect would be that gas sold off the leased premises would be treated as gas sold at the wells, thus creating the overlap. General rules of construction dictated against the result. Furthermore, the supreme court narrowly defined the gas royalty term "premises" to mean leased premises. Consequently, the supreme court in *Middleton* limited *Butler's* "field of production" ruling in holding that gas sold "off the premises" was not sold "at the well" and accordingly entitled royalty owners to market value royalties. The ruling in *Middleton* though, may be susceptible to the argument that if changed circumstances place the gas plant close enough to the boundary line of the leased premises then the reasoning successfully advanced by the producer in *Butler* would apply. Specifically, the economic realties of the situation would dominate consideration of whether a gas sale may be both "at the well" and "off the premises" in interpreting controlling gas royalty language and the result may concide with *Butler*.[196] However, royalty owners may alternatively argue that the supreme court purposely avoided direct reference to distance in order to stress that the boundary lines of leased premises strictly controlled this issue. In effect, the supreme court in *Middleton* narrowly construed the gas royalty phrases "at the well" and "off the leased premises" against their drafter while the civil appeals court in *Butler*, which was more sympathetic to

196. Professor John S. Lowe provides an argument against the the supreme court's rule in *Middleton* with the following example:

> Suppose . . . that A Company leases from O under four separate but identical leases containing the *Middleton* royalty formulation or similar languge, in sections 1, 2, 3, and 4 in a township. Suppose further, [that] the wells are drilled on each of the four sections and that the gas from the wells is committed to sale under a single gas contract. Suppose finally, that the gas pipeline at which deliveries are made angles in a southwesterly-northeasterly direction across sections 2 and 3 so that the meters for the wells on leases on 3 and 4 are set on lease 3 while the meters for the wells on leases 1 and 2 are set on lease 2. If the gas contract provides, as is typical, that the ownership of the gas passes at the meter, then under the *Middleton* decision, royalties on gas from the wells on sections 2 and 3 would be calculated on the basis of the amount realized by the lessee [producer] under the terms of the gas contract, while royalties on the gas from the wells drilled on sections 1 and 4 will be calculated on the basis of current market value when delivered.

Professor Lowe believes that this example points to the impracticality of the decision in *Middleton* as to when gas is sold "at the well." Discussion with John S. Lowe, Professor of Law and Associate Director of the National Energy Law and Policy Institute, University of Tulsa College of Law (March 15, 1981).

the financial difficulties entailed in gas production, more liberally construed almost identical gas royalty language.[197]

B. *When is Market Value to be Determined*?

The Texas Supreme Court in *Middleton* agreed with previous market value controversy decisions on the issue of when gas is "sold." Producers, though, may rely on the dissent in *Vela* which regards these decisions as suspect for the reason that the lease in *Foster* expressly provided for royalties on the basis of continuing sales while the more common leases in *Vela*, and the *Exxon* cases, did not explicitly provide for continuing sales. This argument urges that a gas sale occurs at the time of delivery only where the controlling gas royalty clause contains continuing sales language.[198] Moreover, because explicit continuing sales language is not common to a market value-proceeds royalty clause, such an argument also warrants that gas generally be considered "sold" not on a daily basis, but when the controlling long-term gas contract is executed.[199]

One of the threshold problems in determining when gas is sold is ascertaining the parties intent. Arguments can be advanced in support of either position regarding when the parties perceived the gas as sold. However, one essential point to remember, is that contractual obligations pertaining to gas contracts should not to be interposed with royalty obligations imposed by the lease under *Middleton*. The two are separate and distinct. Arguably, the royalty owner should not be penalized for the responsibility which the producer has assumed via his long-term gas contracts. *Middleton* may also be consistent with *Vela* and *Foster* in that, arguably, the financial realities of the oil and gas industry do not affect the express obligations of a producer under a controlling gas royalty clause. However, the supreme court's holding in

197. Note 67 *supra*. *Contra*, First Nat'l Bank In Weatherford, v. Exxon Corp., 597 S.W.2d 783, 786 (Tex. Civ. App. 1980, *writ pending*).

198. If express language referring to continuing sales is a prerequisite to determining when gas is sold, the market value royalty provision in a market value-proceeds gas royalty clause may be nullified. In other words, suppose that at the execution of a long-term gas contract the price agreed upon by the parties to the controlling lease was judicially determined to be the market value prevailing at the execution of the gas contract. In such instance, even after a rise in market value the producer can satisfy both the market value and proceeds provisions of a market value-proceeds gas royalty clause by merely paying proceeds royalties because the proceeds equals the prevailing market value at the execution of the long-term gas contract.

Furthermore, the Texas' four-year statute of limitations may prevent any liability by the producer for insufficient royalty payments. See note 11 *supra*.

199. A producer's chances of having such a definition judicially enforced will be enhanced where that producer meets its implied obligation to market. *See* note 9 *supra*.

Middleton may not be consistent with the customary acquiesecence by royalty owners to the payments of proceeds royalties where controlling gas royalty clauses required that market value royalties be paid. Moreover, the supreme court's ruling may be inconsistent with the royalty owners' knowledge that gas could not be sold on a daily basis but had to be sold under long-term gas contracts. Regardless of potential flaws in *Vela* as noted by the dissenters therein, it appears to be well established in Texas and the Fifth Circuit that gas is "sold" when delivered; no court in these jurisdictions has held gas to be "sold" when a long-term gas contract is executed. The Louisiana federal district court in *Domatti* is also in accord with this view. In the execution of new oil and gas leases, producers may escape the ruling that gas is "sold" when delivered by defining "sold" to mean a sale at the execution of a subsequent controlling gas contract.[200]

C. *Determining Market Value*

1. The Definition of Market Value to be Applied

Generally speaking, two basic definitions of market value have been applied for determining the market value of a gas sale in a market value controversy. These definitions are dependent upon the legal quality of the gas sale in question. Where a gas sale involves only intrastate gas, market value has only been defined as the theoretical free market value of gas sold. The supreme court in *Middleton* and the *Exxon* cases accepted this position. Though *Vela* did not expressly define market value, it arguably implied that the supreme court applied a theoretical market value because the court considered only unregulated intrastate gas sales. In the Fifth Circuit, where an interstate gas sale has been involved in a market value controversy case, market value is commonly defined by *Weymouth's* regulated market value definition. However, in the state court decision in *Lightcap*, the market value for an interstate gas sale in question has been defined by the theoretical free market value. Therefore, until the opinions of the federal district court in *Domatti* and the Fifth Circuit in *Kingery*, producers were faced with the possibility that *Lightcap's* reasoning would be found persua-

200. If, for instance, *Lightcap's* ruling is rejected by the Texas Supreme Court, royalty owners in Kansas, and possibly Montana, will still be able to collect theoretical free market value royalties from gas sold in a price regulated market. *See* note 64 *supra* and accompanying text.

sive by a court adjudicating a market value controversy case involving interstate gas sales.

Lightcap's definition of a theoretical free market value was derived from the Kansas Supreme Court's interpretation of *Huber*. The supreme court had interpreted *Huber* to mean that a market value royalty provision on its face required the theoretical free market value. This reasoning in *Lightcap* has been circumvented by the court in *Domatti* where the producers successfully argued that *Mobil Oil's* "fair presumption" dictum required that *Weymouth's* regulated market value definition be applied. Moreover, the court in *Domatti* stated that *Weymouth* merely defined the relevant market which its companion case, *Huber*, had said the parties intended at the execution of the controlling lease.[201] Furthermore, the court in *Domatti* found it persuasive

201. *Contra*, First Nat'l Bank In Weatherford v. Exxon Corp., 597 S.W.2d 783 (Tex. Civ. App. 1980, *writ pending*). In *Weatherford*, producer Exxon paid proceeds royalties, which was computed from the amount received from the gas sales in question under a long-term gas contract executed in 1967. The natural gas was irrevocably committed to interstate commerce. Consequently, the proceeds royalties were computed from the federal price ceiling established over the interstate gas market. The leases, executed in 1960, did not contain a market value-proceeds royalty provision; the gas royalty clause did not obligate the producer to pay market value royalties or proceeds royalties depending upon whether the gas was sold on or off the leased premises. Instead, the controlling gas royalty clauses obligated the producer to pay to the royalty owner "the value of all oil and gas produced and saved from said leased premises." *Id.* at 785. The same expert who had testified for the royalty owners in *Middleton* also testified in Weatherford to basically the same method for determining market value. Exxon's expert used four comparable sales and arrived at a weighted average. *Id.* at 788 (dissenting opinion).

The civil appeals court in *Weatherford* rejected the royalty owner's expert's testimony that intrastate gas sales were comparable to the interstate gas sales in question. The civil appeals court in *Weatherford* stated: "The sale of this [interstate] gas was restricted and its marketability thereby affected; it could not be sold in the intrastate market so its value in that market was zero. *Id.* at 786 (citing Phillips Petro Co. v. Ochsner, 146 F.2d 138, 141 (5th Cir. 1944)). Furthermore, in accord with Hemus & Co. v. Hawkins, 452 F. Supp. 861 (S.D. Tex. 1978), the civil appeals court in *Weatherford* found that "[i]n the field of eminent domain, where, as here, comparables are used to determine market value, Texas law excludes evidence of sales of unrestricted property as comparable in finding the value of property which is burdened with restrictiveness." 597 S.W.2d 786 (citing City of Austin v. Cannizzo, 267 S.W.2d 808, 815 (Tex. 1954)). The civil appeals court found this rationale to be consistent with the federal district court decisions in *Brent* and *Hemus*. *See* note 101 *supra*. Citing *Vela*, the civil appeals court noted that the royalty owner's claim for market value royalties was premised on gas sold when run on a daily basis. The court noted that this claim failed on the basis of insufficient evidence. Finally, the civil appeals court excluded the relevance of *Vela* as to *Weatherford*, by emphasizing that *Vela* had not involved regulated gas sales. Consequently, even *Vela's* comparability test was excluded from consideration. *Id.* at 786. Not suprisingly, the civil appeals court in Weatherford rejected all evidence that there were sales comparable to the regulated sales in question. The trial court in *Weatherford* held:

> The only gas sales which may be comparable to to the sale involved in this case are sales to the interstate market of gas of the same vintage as the gas involved in this case made by a similar producer. All other sales, and specifically intrastate sales, are not comparable to the sale involved in this case and are therefore not relevant to the market price of the gas involved in this case.

Id. at 789 (dissenting opinion). The civil appeals court in *Weatherford* affirmed the trial court's

that *Lightcap* never reached the question of market value so that the definition it applied was was only dictum. The Fifth Circuit in *Kingery* has also afforded producers an argument to circumvent *Lightcap's* reasoning. *Kingery* accepted the Supreme Court's dictum in *Southland* that even where a lease has been executed before the decision in *Phillips Petroleum Co. v. Wisconsin*, let alone the enactment of the NGA, the royalty owners must accept royalties based upon *Weymouth's* regulated market value definition. If the reasoning in *Lightcap* as to the definition to be applied can be effectively countered the definition of market value to be applied in a market value controversy case will certainly depend upon the legal quality of the gas in question. Consequently, where the gas sale in question is unregulated, the definition would be a theoretical free market value definition; where the gas sale in question is regulated, the definition would be a regulated market value definition similar to *Weymouth's* definition of market value. This is significant because the definition of market value affects the scope of the test with which the definition is implemented.

2. Determining Comparable Sales

Since the Texas Supreme Court decision in *Vela*, the well-established test for determining the theoretical or regulated market value of gas sold has been by sales comparable in time, quality and availability to marketing outlets. *Vela's* comparability test has been accepted by all

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ruling. *Id.* at 787. The dissent emphasized that where the royalty owner had no control over the sale of gas by a producer and knew nothing of a sale until after execution of the gas sales contract, then the lease became, by the majority's ruling, a unilateral agreement subject to the execution of a gas sales contract. *Vela*, *Lightcap* and the federal district court decision in *Kingery* were generally cited and relied upon.

The civil appeals court's statement in *Middleton* that *Vela's* comparability test would not be used in a regulated market is consistent with the majority opinion in *Weatherford*. Significantly, the supreme court and civil appeals court in *Middleton* both distinguished, in dictum, gas sold in intrastate and interstate commerce. The supreme court went further by stating that gas sold in intrastate and interstate commerce were "conceptually and legally different." Consequently, it appears that where a pre-NGPA interstate gas sale is at issue in a market value controversy case, courts may not apply *Vela's* comparability test but instead might equate market value with proceeds. Presumably market value and proceeds would be theoretically synonymous in the absence of *Vela's* comparability test, at least where regulated gas is concerned. Where an NGPA regulated gas sale is in question, the possibility of excluding *Vela's* comparability test is probably greater. In this case, all gas sold in both interstate and intrastate commerce would be regulated.

The *Weatherford* decision was also contrary to those decisions which have considered the issue of when gas is "sold" by holding that the gas was sold when the controlling long-term gas contract was executed. However, this reasoning is consistent with the position that market value and proceeds are theoretically the same. In short, *Weatherford* may be construed as supporting the position that market value and proceeds are theoretically equal where a Federally regulated gas sale is in question in a market value controversy case.

courts which have been faced with an issue of market value determination in a market value controversy. Comparable sales must be drawn from the same marketing area. *Middleton* stated the corollary that a marketing area exists when comparable sales may be drawn from it. This ruling has extended the supreme court's dictum statement in *Vela* that the field of production is not the final answer to the definition of the marketing area. Unlike dictum in *Butler* that the field of production would almost conclusively be the marketing area, *Middleton* has potentially provided the most expansive holding to date in the Texas state court system concerning the definition of the marketing area. Arguably, by the supreme court's definition, there need only be a marketing area from which comparable sales may be drawn. Therefore, a producer is not restricted to the field of production in determining comparable sales. In accord with *Middleton*, a producer need only provide an area with gathering and transporting facilities for gas produced. Furthermore, the use of a marketing area which other producers also use will be persuasive. The producer may arguably use one field of production for several other gas fields as long as sales are comparable. Moreover, the marketing area need not be another field of production but only a portion of one possibly defined by county lines or TRC district boundaries.

The Fifth Circuit's definition of marketing area has not reached the limits of the supreme court in *Middleton*. Arguably the Fifth Circuit has impliedly overruled the "immediate vicinity" definition for marketing area arrived at by the federal district court in *Kingery*. This may have been accomplished when the Fifth Circuit held that regulated market value was synonymous with the FPC ceiling rate. Moreover, in upholding *Brent*, *Kingery* may have determined that the geographical areas over which FERC ceiling rates are set is the marketing area from which comparable sales will be drawn when FERC price regulated gas sales are involved. Nevertheless, the *Middleton* decision may be highly persuasive since there appears to be no well-established definition of a marketing area in the federal courts.

3. Application of *Vela's* Comparability Test

The supreme court in *Middleton* provided the most complete analysis of *Vela's* comparability test to date. The *Middleton* court held that the market value of an intrastate gas sale in a market value controversy case should be determined from sales comparable in time, quality,

quantity, and availability to marketing outlets.[202] In effect, the court in *Vela* merely recited the comparability test and stated that the gas sales accepted by the trial court as comparable met that test. Relatively little analysis was involved in *Vela*. This lack of analysis has been prevalent in market value controversy cases which have invoked *Vela's* comparability test. The exception to this lack of analysis has been the courts' special concern for the legal quality of the gas in question. Unlike the other elements of comparability in *Vela's* test, there has been a great disparity between prices paid for natural gas depending upon the legal quality of such gas. Whether the gas in question in a market value controversy case has been sold in interstate or intrastate commerce has determined its legal quality because of the effect of the NGA on interstate gas sales prices. In *Vela*, the court stated that the contract sales price was not necessarily the market value. Recognizing the position that the value of gas is zero on a market in which it cannot be sold, the federal district court in *Domatti*, and the Fifth Circuit in *Kingery* have basically rejected the argument that the parties intended that both interstate and intrastate gas prices be included in computing market value for an interstate gas sale in question. The fact that the parties knew that gas sold in interstate commerce might be subject to restrictions has been expressed in *Southland Royalty Co*. The courts in *Domatti* and *Kingery* have consequently concluded that only interstate gas is comparable to an interstate gas sale in question.[203] Conse-

202. Only the comparability element of legal quality was vigorously contested in *Middleton*. In considering physical quality, the supreme court basically stated that gas need have only the same lack of impurities and same heating capacity in order to be physically comparable. The court found persuasive that knowledge of a gas' heating capacity rendered the new element of quantitative comparability useless. The supreme court found persuasive that the marketing area was interconnected through a complex intrastate and interstate pipeline system. A more commonly contested issue has concerned the element of time. The controversy over this element has revolved around the use of tri-monthly price data or monthly price data. *Butler*, and the civil appeals court in *Middleton*, found persuasive the fact that monthly price data was more in line with the daily sales of the gas industry. But the supreme court in *Middleton* has, in effect, recognized the practicality of using tri-monthly price data since the Texas State Comptroller's Office only processes PMG reports on a tri-monthly rate. Though these elements are considered in determining comparable sales, legal quality has been the most significant element in the determination of comparable sales.

203. It is significant that the supreme court in *Middleton* completely disregarded, as legally binding, the rules in *Vela* which were based on expert testimony. The supreme court in *Vela* had held that a volume-weighted average of all gas prices in the field of production was the mathematical formula to be applied in determining the market value of the gas sales in question. The supreme court in *Middleton* rejected the volume-weighted average formula. However, the supreme court in *Middleton* neither overturned nor applied *Vela's* holding. This result is attributable to the fact that a market value controversy outcome is highly dependent upon the peculiarities of each case. The realities of the gas industry practically necessitate the use of expert testimony. Therefore, objections to the basis of an expert's testimony goes to its weight, but not its

quently, market value has been equated with proceeds as a practical effect of these rulings. Furthermore, the Supreme Court's holding in *Pennzoil* is consistent with the equating of market value with proceeds, or the FERC ceiling rate, where individualized relief is available from the FERC.[204] Significantly, however, market value and proceeds remain theoretically different concepts in the market value controversy.[205] Although dictum, the supreme court in *Middleton* has nevertheless stated that intrastate gas is conceptually and legally distinguishable from interstate gas. Quite possibly, if *Middleton's* dictum is any indication, the Texas state courts will follow the results in *Kingery* and in *Domatti*, where royalty owners attempt to compare unregulated intrastate gas sales with an interstate gas sale in question in a market value controversy.

4. Determining Market Value from the Mathematical Computation of Comparable Gas Sales Prices

Once comparable sales are determined, the issue to be considered has been the mathematical method for computing the theoretical free market value of the gas sales in question in a market value controversy from the comparable gas sales. Before the energy shortage, a volume-weighted averaging, as applied in *Vela*, was appropriate because the disparity between market value and proceeds which later developed did not exist.[206] The civil appeals courts in *Middleton* and *Jefferson Land Co.* agreed with *Vela* in using a volume-weighted average of all gas prices paid in a field by excluding gas sales before the energy shortage in order to prevent a depression of the judicially determined theoretical free market value for the intrastate gas sold. The supreme court in *Middleton* found it persuasive that the averaging of the three highest prices in a marketing area was necessary in order for a judi-

admissibility. The supreme court in *Vela* agreed with this position. Furthermore, even testimony which includes consideration of interstate sales may be admissible as evidence. *But see* note 203 *supra*. The supreme court in *Middleton* recognized that, in effect, the fact finder was the judge. The supreme court cited *Weymouth* in support of this position. This rule appears to be well-established in both the Texas judicial system and the Fifth Circuit. In short, while *Vela's* comparability test is a rule of law to be followed by the Texas judicial system and the Fifth Circuit, where Texas law is to be applied to a market value controversy, the factual conclusions of law reached under *Vela's* comparability test, including those reached by the supreme court in *Middleton*, are not rules of law.

204. *But see* note 201 *supra*.

205. *See* Comment, Vela: *Legacy of Conflict Over Determination of Market Value for Royalties on Interstate and Interstate Gas and Continued Controversy with the Natural Gas Policy Act of 1978*, 11 ST. MARY'S L.J. 502, 524-32 (1979).

206. *See* note 103 *supra*.

cially determined market value to represent the escalating theoretical free market value of the intrastate gas sales in question. Consequently, though the volume-weighted averaging in *Middleton* was overruled, the supreme court might arguably consider a qualification to a volume-weighted average persuasive, such as that made in *Jefferson Land Co.* which allows such an average to represent the escalating theoretical market free value of of a gas sale in question. In short, a mathematical method which computes the escalating free market value of a gas sale in question from comparable gas sales prices will be accepted.

D. *The Effect of the NGPA*

A market value controversy case concerning royalties paid for interstate gas sales has not been ultimately resolved in a state judicial system. But with the enactment of the NGPA has come the inevitability that a state judicial system will be confronted with a market value controversy case concerning royalties paid for federally regulated intrastate gas sales. Generally speaking, the NGPA has made gas sold in intrastate and interstate commerce legally comparable under *Vela's* comparability test in a congressional effort to abolish the great disparity between market value for unregulated intrastate gas sold and the federal ceiling rates under the NGA. Consequently, the differences in legal quality, which was premised upon the difference between a market value measurement, and a proceeds measurement which was limited by a suppressed ceiling rate, have conceivably been abolished until 1985. The courts in *Domatti* and *Kingery* qualified their comparison of market value and proceeds by emphasizing that gas sold in interstate and intrastate commerce were legally different and, therefore, market value and proceeds were only equated as a practical result of their rulings and not as a theoretical result. Arguably, the NGPA has made FERC ceiling rates and market value equal so that the comparability element, or legal quality, in *Vela's* test which has been so vigorously contested by producers and royalty owners is, practically speaking, no longer a contestable issue. Consequently, *Vela's* comparability test may be of no use where the FERC ceiling price for a NGPA regulated gas sale in a market value controversy case is theoretically the market value of that gas until 1985. Significantly, however, the supreme court in *Middleton* has found not only a legal, but a conceptual, difference between gas sold in interstate and intrastate commerce. Even assuming that the NGPA does decrease the great price disparity between market

value and federally regulated proceeds, arguably the NGPA regulated intrastate gas sales remain conceptually different for the reason that the NGPA regulated interstate gas will remain irrevocably committed to interstate commerce in 1985 when the gas sold in intrastate commerce will be largely deregulated. Therefore, applying the reasoning in *Lightcap*, where market value was found to be higher than the federal price ceiling for the interstate gas there in question, and *Vela's* comparability test, royalty owners could argue that market value is not theoretically equal to the FERC ceiling price over the gas sale in question but is equal to the prevailing market value of, at least, conceptually comparable sales during the sale in question. The prevailing market value may be at most the highest FERC ceiling rate for the reason that all gas sales are regulated under the NGPA until 1985. Nonetheless, it must be emphasized that the NGPA deflates the main reason for the use of *Vela's* comparability test: price disparity.

V. CONCLUSION

Ostensibly, the NGPA will deregulate in 1985. Gas formerly sold in unregulated intrastate commerce will be largely deregulated. Consequently, gas will be sold in interstate commerce and intrastate commerce similarly to the way gas was sold after *Phillips Petroleum Co. v. Wisconsin* but before the enactment of the NGPA. Perhaps in 1985 the purpose of the NGPA will have been accomplished: the amelioration of the price disparity between the market value of gas sold in the unregulated intrastate commerce and federally controlled interstate sales under long-term gas contracts. Nonetheless, producers should plan for the prevention of market value controversy cases. There is one basic solution for producers—avoid the market value-proceeds royalty clause. Avoiding this clause will not change the meaning of "sold" unless "sold" is defined in the lease to mean the time of the execution of a subsequent controlling gas contract. But it will eliminate the question of when gas is "sold off the premises." It will eliminate the payment of market value royalties where only a proceeds royalty provision is placed in a gas royalty clause. But if a market value provision is to be used, then market value must at least be defined within the lease as the federally regulated ceiling rate where the royalty owner's gas is sold in interstate commerce. Considering the economic realities of the gas industry, and the burdensome obligations of a producer which have resulted under the express language of market value-proceeds royalty

provisions, the gas royalty provisions should be less strictly construed against the producers.[207] In any case, producers must not hide behind the short-lived pricing scheme of the NGPA but must execute and amend their leases as if the NGPA were not in force.

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207. *See* note 73 *supra*. Furthermore, even where such provisions are less strictly construed, royalty owners are no less protected where the producer has breached an implied covenant to market. *See* note 9 *supra*.