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THE COOPERATIVE VENTURE: REVISITING THE RELATIONSHIP BETWEEN THE ROYALTY AND WORKING INTEREST IN TEXAS

INTRODUCTION

A. *Background*

The Lessor/Lessee Relationship in the Oil and Gas Lease

The oil and gas industry has certainly evolved since "Colonel" E. L. Drake struck oil on August 28, 1859,[1] and the relationship between the land owner and oil company has been a significant part of that evolution. Oil companies do not typically acquire the land on which they explore for and produce oil and gas.[2] Generally, the oil company enters into an oil and gas lease with the landowner that entitles the oil company to the mineral rights associated with the land and to develop the property in order to extract those minerals.[3] In exchange for allowing the oil company to develop the land, the landowner typically retains a fractional royalty interest in the minerals.[4] This entitles the landowner to receive his share of the proceeds on the sale of the oil or gas with no obligation to share in the cost of extracting the minerals from the ground.[5] If there is a large amount of oil or gas produced on the lease, the landowner will receive a large royalty; if there is a small amount of production, the royalty will be proportionately smaller.[6] Historically, a one-eighth royalty interest has been common,[7] though in recent years it is not uncommon to see a larger fraction negotiated.[8] The landowner generally has the right to sell his share of production

1. *See* DANIEL YERGIN, THE PRIZE 27 (1992). The drilling leading to the discovery was done on August 27, 1859, then worked stopped for the weekend. Uncle Billy Smith actually went to the drill site and looked down the pipe and saw oil floating on top of the water on August 28, 1859. *See id.*

2. *See, e.g.,* RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 2.5 (3d ed. 1991) (discussing the relationship between the lessor and lessee).

3. *See id.*

4. *See id.* The royalty interest generally is the interest retained by the landowner who has entered into an oil and gas lease with the lessee oil company. WILLIAMS & MEYERS, *infra* note 7 at 952. The working interest is the interest acquired by the lessee and carries the burden of paying all production costs up to the point oil or gas reaches the wellhead. *See id.* at 1191.

5. *See id*

6. This historical sharing of risk between the landowner and oil company is no small point. It seems to point to a relationship between the two parties more accurately represented by the cooperative venture approach discussed below. Both parties benefit from good well performance or suffer from poor performance in amounts relative to each other.

7. *See* HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 947 (10TH ed. 1997).

8. *See id.*

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separately from the oil company's sale of the remaining seven-eighths of production by receiving his share in kind;[9] however, the more common scenario is for the landowner to permit the oil company to "market" both shares.[10] That is, the oil company sells the entire "eight-eighths" and passes the landowner's share to the landowner in the form of a royalty check.

An example of a typical royalty clause in a Texas oil and gas lease is:

> [T]he royalties to be paid by Lessee [oil company] are: (a) on oil, one-eighth of that *produced and saved from said land*, the same to be delivered at the wells or to the credit of Lessor [landowner] into the pipe line to which from time to time purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase; (b) on gas, including casinghead gas or other gaseous substance, produced from said land, and sold or used off the premises . . . 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.[11]

Many of the cases discussed in this Comment, as well as overall in the industry with respect to the royalty clause, focus on the phrases "produced and saved" and "market value at the well." Much of the litigation in Texas relating to the oil and gas industry has involved the interpretation of those terms in the oil and gas lease.[12]

The *cooperative venture* approach and the *plain meaning* approach are two primary approaches used to interpret the terms of an oil and gas lease. These terms are defined in more detail below. Briefly, the cooperative venture approach assumes that the royalty and working interest have entered into a relationship in which both parties have a common objective of receiving the highest return possible from the production of oil or gas from the lease. As such, an assumption is made that both parties should be treated the same in areas such as the price paid on oil or gas produced. The plain meaning approach simply applies the canon of construction which states that terms of the lease should be given the plain meaning usually applied to those terms.

B. *Statement of Position*

Texas should adopt the "cooperative venture" approach with respect to the relationship between royalty and working interest owners.[13] Historically, Texas has followed the majority "plain meaning"

9. *See id.*
10. *See* HEMINGWAY, *supra* note 2, § 7.4.
11. *Id.* at 591 (emphasis added).
12. Examples are included in the discussion of cases in Part II. B., *infra*.
13. For purposes of this Comment, the terms working interest, lessee, and operator are synonymous. The terms royalty interest, lessor, and landowner, likewise, are used interchangeably.

rule.[14] This Comment argues that the cooperative venture approach is more consistent with the relationship between the royalty and working interest, is fairer to both parties in common areas of dispute, and should reduce overall litigation in the oil and gas industry.

In order to avoid the extreme results of both the plain meaning and the cooperative venture, this Comment argues for expansion of the use of the term "constructive production"[15] to protect both the royalty and working interests' rights. To protect the royalty interest, the definition of constructive production should be expanded to include situations where actual production through the well bore has not physically occurred, but where circumstances tantamount to production have occurred.[16] To protect the working interest, the cooperative venture should be narrowly defined to include only those situations where production or *constructive production* have occurred.[17]

Part I of this Comment defines the cooperative venture rule and the plain meaning rule as they are used by courts to interpret oil and gas leases. Part II, reviews and analyzes the cases adopting the cooperative venture rule in our neighboring states of Oklahoma, Louisiana and Arkansas, as well as some of the Texas cases where the plain meaning rule has been applied. Part III, discusses the concept of constructive production and how it should be incorporated into the cooperative venture rule. As part of that discussion, this Comment

14. All but three oil and gas producing states use the plain meaning rule; however the three which do not, Oklahoma, Louisiana, and Arkansas, have significant and long-standing oil and gas industries. Texas first applied the plain meaning rule to the royalty clause in *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968). *See* detailed discussion *infra* Part II. B. 1.

15. Historically, the drafters of oil and gas leases have included provisions which equate certain actions to actual production. For example, once production has begun on the lease, it must be maintained or the lease can be lost. Drafters of oil and gas leases have included a shut-in royalty provision which allows for the payment of shut-in royalties in lieu of production (i.e., production has been temporarily stopped) to keep the lease alive. The shut-in royalties are considered constructive production. *See* HEMINGWAY, *supra* note 2, §6.5.

16. For example, this Comment argues that illegal drainage by an adjacent lease which was recovered by the working interest through litigation should be considered to be constructive production. Another example would be where oil or gas has been extracted from the lease but not through the actual well bore. In these situations the royalty interest's rights would be the same as had the production physically occurred through the well bore and would no longer be available for recovery by the royalty interest.

17. Examples of problematic questions that arise under the cooperative venture approach appear to include whether the royalty interest has a right to share in tax refunds or hedging gains and losses. A narrow definition of the cooperative venture would exclude those activities because they do not represent the value of the actual royalty share of oil or gas. This is, admittedly, a subjective call. But critics of a broadly construed cooperative venture rightly express concern that a broadly construed rule overwhelms the historical relationship between the parties. Telephone Interview with John S. Lowe, George W. Hutchison Professor of Energy Law at Southern Methodist University School of Law in Dallas, TX. (April 12, 1998). Limiting the rule to actual or constructive production will address much of that concern.

addresses some of the activities of an oil and gas company which would appear to fall outside of the definition of constructive production and, therefore, the cooperative venture. The Conclusion, summarizes the argument in favor of adopting the cooperative venture rule in Texas. The covenants found to be implicit in an oil and gas lease are beyond the scope of this comment; however, some of those covenants have clearly influenced the courts that have adopted the cooperative venture rule.[18]

I. THE DEFINITIONS

A. *The Cooperative Venture Rule*

The cooperative venture rule is, in effect, a canon of construction which applies to interpreting oil and gas leases.[19] Under the cooperative venture rule, there is an assumption that the royalty and working interests have a common goal of achieving the highest price possible for oil or gas sold from the lease.[20] They have entered into a venture in which "the lessor contribut[es] the land and the lessee contribut[es] the capital and expertise necessary to develop the minerals for the *mutual benefit of both parties*."[21] Implicit in this venture is the "affirmative, although implied[,] obligation of the lessee to market or dispose of the product in a reasonable and prudent way to secure the maximum benefit possible for both parties."[22] That duty subjects the working interest to uncertainties in the market place such as the large price swings experienced in the industry,[23] the uncertainty that a market for the product will be found (particularly in the case of natural gas),[24] and the possibility of the need to construct a delivery system to transport the product to that market.[25] The cooperative venture rule attempts to take these uncertainties into consideration, particularly

18. Most notably, the covenant to market has influenced the adoption of the cooperative venture rule. For a discussion of the implied covenants associated with an oil and gas lease, see HEMINGWAY, *supra* note 2, §§ 8.1 – 8.9.

19. *See generally* Tara Petroleum v. Hughey, 630 P.2d 1269, 1273 (Okla. 1981) (Although this case does not use the term cooperative venture, the analysis is in keeping with this rule).

20. *Id.*

21. Henry v. Ballard & Cordell Corp., 418 So. 2d 1334, 1338 (La. 1982) (citing Thomas A. Harrell, *Developments in Non Regulatory Oil & Gas Law*, 30 INST. ON OIL & GAS L. & TAX'N, 311,334 (1979) (emphasis added).

22. *Id.* (quoting Harrell, *supra* note 21).

23. See YERGIN, *supra* note 1, at 792.

24. Due to its physical characteristics, natural gas is transported by pipeline to the end-user. *See* WILLIAMS & MEYERS, *supra* note 7, at 790-91.

25. *See, e.g.,* YERGIN, *supra* note 1, at 572 -74 (discussing the problems associated with transporting Alaskan crude oil from the North Slope to the oil tankers off the coast of southern Alaska).

the implied duty to market to which the working interest is subject.[26] As Professor Lowe points out,

> [T]he [cooperative] venture analysis is not substantially different from treating the oil and gas lease as a relational contract, an agreement in which the parties are incapable of reducing important terms of the agreement to well-defined obligations, perhaps because the problems that the contract should address cannot be predicted accurately or because the parties are unable to agree upon solutions to problems that may arise.[27]

A relational contract is one in which the parties have not attempted to define the specifics of the contract but, rather, have established a relationship in which an implicit obligation of good faith exists to overcome problems encountered.[28] This seems to go too far in defining the relationship between the royalty and working interest, but the cooperative venture approach does recognize the inherent uncertainties in the oil and gas business and allows for certain unanticipated issues to be resolved as they are encountered.[29]

B. *The Plain Meaning Rule*

The plain meaning rule, in the context of the relationship between the working and royalty interest, is simply an application of the broader plain meaning canon of construction.[30] It means that a term such as market value "is a 'plain term' that must be given its usual meaning."[31] In the case of a royalty clause calling for payment of the royalty based on the "market value" of the oil or gas, that would be "the price a willing buyer and seller would agree upon at the time of production,"[32] irrespective of the actual amount realized by the seller under the specific circumstances. The plain meaning rule as applied to the interpretation of oil and gas contracts is the majority rule at this point.[33]

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26. The implied duty of the working interest to market the oil or gas is a well established obligation of the lessee. *See* HEMINGWAY, *supra* note 2, §§ 8.1-8.9. The lessee has an obligation to market the product within a reasonable time and at a reasonable price. *See id.* at § 8.9(C). It is the existence of this implied duty that seems to point to the cooperative venture rule as being a fairer view of the relationship between the parties with respect to both market price and take-or-pay settlements, discussed more fully infra.

27. John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. Rev. 223, note 86 (1996) (citing Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1092 (1981)).

28. *See id.*

29. *See, e.g., Henry*, 418 So. 2d at 1338.

30. *See generally*, Lowe, 49 SMU L. REV. at 233 (1996).

31. *Id.*

32. *Id.*

33. *See Henry*, 418 So. 2d at 1337-38.

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II. THE CASES

A. *The Cooperative Venture Rule—Oklahoma, Louisiana and Arkansas*

1. *Tara Petroleum v. Hughey*—Oklahoma

Oklahoma was the first state to adopt the cooperative venture approach through it's Supreme Court's decision in *Tara Petroleum Corp. v. Hughey*.[34] In that case, Tara entered into an oil and gas lease in 1973 with four heirs of William Hughey that conveyed to Tara a seven-eighths working interest, with a one-eighth royalty interest retained by the heirs.[35] Six months later, Tara assigned its interest to Coy Brown, retaining an overriding royalty of one-eighth of the seven-eighths working interest and reserving the right to purchase any gas produced at 31 cents per Mcf.[36] Through various other assignments, the lease ultimately was held by Brown's corporation, Wilcoy, and several individuals.[37] A producing gas well was drilled in 1976, and Wilcoy entered into a gas purchase contract with Jarrett Oil Company as buyer.[38] Wilcoy terminated the contract in 1978.[39] During the two year period, Jarrett paid Wilcoy 32 cents per Mcf the first year and 33 cents per Mcf the second year.[40] Jarrett sold the gas it had purchased from Wilcoy to El Paso Natural Gas (El Paso) at the Federal Power Commission ceiling price which approached $1.30 per Mcf during that period.[41] To simplify, the working interest lessee sold the gas produced to Jarrett, the purchaser, under a gas purchase contract and paid the royalty interest based on that price. Jarrett sold the gas to El Paso at a much higher price. Jarrett had no direct relationship to the royalty owners. The royalty owners sued all of the working interest owners, claiming additional royalties.[42] They pointed to the lease which stated in part that the "lessee covenants and agrees . . . [t]o pay lessor for gas . . . at the market price at the well for the gas sold."[43] The lessors claimed they were entitled to royalties based on the price El Paso paid Jarrett because it indicated the true market value at the time the gas was sold.[44]

The question before the court was whether the "contract price," i.e. the price the working interest lessee gets according to the gas

34. 630 P.2d 1269 (Okla. 1981).
35. *See id.* at 1271.
36. *See id.* Mcf stands for one thousand cubic feet, a common unit of measure of gas volume in the industry. *See* WILLIAMS & MEYERS, *supra* note 7, at 611.
37. *See* Tara Petroleum Corp. v. Hughey, 630 P.2d 1269, 1271 (Okla. 1981).
38. *See id.*
39. *See id.*
40. *See id.*
41. *See id.*
42. *See id.* at 1272.
43. *Id.*
44. *See id.*

purchase contract, should be used to define the "market price" under the lease.[45] The court held that it should.[46] The court stated that the royalty interest was only entitled to royalties based on the actual price the working interest lessee had realized from Jarrett, not the apparent true market price based on the third party transaction between Jarrett and El Paso. In so holding, the court noted that the lessee is under an implied duty to the royalty interest to market the gas.[47] To meet that obligation, the lessee often must enter into long-term purchase contracts at prices below current or eventual market prices.[48] The court recognized the inequity of requiring the lessee to market the gas under the implied duty to the royalty interest to market and allowing the royalty interest to receive a royalty based on a higher price.[49] Though the term cooperative venture was not yet used, this is the first decision, which adopted the concept that the working and royalty interests rode in the same car, so to speak, in this venture.

2. *Henry v. Ballard & Cordell*—Louisiana

In the 1982 case, *Henry v. Ballard & Cordell Corp.*,[50] Louisiana became the second state to adopt the cooperative venture rule. In *Henry*, the issue again was the price used to calculate the royalty on gas production.[51] The lessee had entered into a twenty-year gas purchase contract in 1961 that allowed for price escalations over the term of the contract.[52] In 1976, the market price of gas began to exceed the contract price even after escalations.[53] The oil and gas lease included language similar to that found in *Tara*, which called for royalties based on the market price of the gas sold or used.[54] The Louisiana Supreme Court affirmed the court of appeals holding that the royalty should be based on the price realized by the lessee on the sale of the gas.[55] Noting that it had not followed the majority rule, the court stated:

> Although the majority of jurisdictions have interpreted the ambiguity in the royalty provisions against the lessee, they have done so by ignoring the practical realities of the oil and gas industry, and the obligations of the lessee to market the gas at the best possible price at the time the leases were made.

45. *See id.*
46. *See id.*
47. *See id.*
48. *See id.* at 1273.
49. *See id.* at 1274.
50. 418 So. 2d 1334 (La. 1982).
51. *See id.* at 1335.
52. *See id.* at 1335-36.
53. *See id.* at 1336.
54. *See id.* at 1335 (comparing leases in *Tara* and *Henry*).
55. *See id.* at 1337.

> The practical and economic necessities of the oil and gas industry at the time the leases were negotiated are given little or no consideration in the line of cases represented by *Vela*.[56] Because such factors necessarily would have bearing upon the intent of the parties concerning payment of royalties, the result reached in those cases has been greatly criticized.[57]

The court used the term *cooperative venture* to define this relationship between the working and royalty interest.[58] It drew heavily on the *Tara* decision, noting that the interpretation of market value as the price realized by the working interest lessee is the only interpretation fair to both parties.[59]

3. *Hillard v. Stephens*—Arkansas

In a decision announced just ten days after *Henry*, the Arkansas Supreme Court addressed the definition of market value in the royalty clause in *Hillard v. Stephens*.[60] In *Hillard*, the court addressed a fact scenario similar to *Tara* and *Henry*. Beginning in February 1957, the Hillards, as lessors, entered into seven gas leases with Stephens, five of which included a royalty clause stating, "Lessee shall pay Lessor as royalty gas the equal one-eighth . . . of the value of such gas calculated at . . . Prevailing Market Price at Well. . . . "[61] Two of the leases included a royalty clause calling for royalties at seven cents per Mcf.[62] Up until 1970, the royalties were paid based on the net proceeds received by Stephens from its purchaser, Ark-La.[63] In 1970, Stephens began paying the royalties based on a set amount of approximately sixteen cents but could not explain why.[64] The Hillards accepted those royalties without complaint until 1979 when they filed suit for additional royalties based on current market prices at the time the gas was sold.[65] Again, to simplify, the Hillards' royalty had been paid based on the proceeds received by Stephens or some set royalty price but not on the apparent market value indicated by the price for which Ark-La sold the gas to its end user. Both parties appealed decisions by the lower courts.[66]

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56. The court is referring to *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968). The *Vela* case is the Texas case that first used the plain meaning rule with respect to the definition of market price in the royalty clause. It is discussed further below, Part II. B. 1.
57. *Henry*, 418 So. 2d at 1337-38.
58. *See id.* at 1338.
59. *See id.* at 1339 (quoting *Tara Petroleum Corp.*, 630 P.2d 1273-74).
60. 637 S.W.2d 581 (Ark. 1982).
61. *Id.* at 582.
62. *See id.*
63. *See id.*
64. *See id.* The exact amount is not relevant to the issue other than the fact that it was below what the Stephenses argue was the true market value.
65. *See id.*
66. *See id.* at 583.

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On appeal, the Hillards contended "with respect to the first five of the leases, they [were] . . . entitled to a royalty computed on the current market value of the gas in the field determined on a daily basis the moment the gas is produced and/or delivered to Ark-La under the gas purchase contracts."[67] The court held that, instead, the royalty should be based on the gas purchase contract price, not the current market price.[68] The court stated:

> The gas lease constitutes a present sale of all of the gas in place at the time such lease is executed, and as the gas leaves the well head, the entire ownership thereof is in the lessee, none being reserved in the lessor. Once the lessee-producer drills a well resulting in the commercial production of natural gas on the leased premises, the lessee-producer has the immediate duty to market the gas. In order to market such gas effectively, it is the custom in the industry[,] and is usually necessary[,] for the lessee-producer to sell the gas under a long-term gas purchase contract.[69]

The Hillard Court also noted that using the gas purchase contract price to calculate the royalty "is the only interpretation that operates fairly for the [lessee] . . . [and] is not unfair to the [lessor]."[70]

These three decisions all focus on the inequity of requiring the lessee to market gas under an implied duty, which, at the time of these cases, could often only be achieved through a low price long-term contract and requiring that the royalty be paid at a higher market price. All three courts found that the cooperative venture rule more closely reflects the intent of the parties in the lease and results in a more equitable treatment of both parties.

4. *Frey v. Amoco Prod. Co.*—Louisiana

Conceptually, the cooperative venture rule can be applied to other interactions between the royalty and working interest as well. One such interaction receiving the attention of courts recently is the division of proceeds on settlement of take-or-pay obligations or litigation. The circumstances in the natural gas industry in the 1970s and 1980s contributed greatly to the amount of litigation in the industry.[71] Buyers of natural gas in the 1970s were anxious to enter into contracts with producers due to the energy crisis.[72] However, during the 1980s, gas prices declined sharply.[73] The pipelines found themselves in a situation where they were contractually obligated to pay much higher prices under the take-or-pay contract than they could sell the gas for

67. *Id.*
68. *See id.*
69. *Id.* at 583-84.
70. *Id.* at 585.
71. *See* JOSEPH SHADE, PRIMER ON THE TEXAS LAW OF OIL AND GAS 51 (2d ed. 1998).
72. *See id.*
73. *See id.*

at market prices.[74] Many simply defaulted on their contracts.[75] Approximately $44 billion in claims were filed by the producing companies, and ultimately, about $8 billion in settlements were reached.[76] Many of the lessees who had settled these claims refused to pass on any portion of the proceeds to the royalty interest, claiming that no actual production had occurred.

The majority rule is that the royalty interest does not have a right to share in take-or-pay settlements or litigation.[77] This rule is based on the theory that actual production has not occurred.[78] However, in the 1992 decision, *Frey v. Amoco Prod. Co.,*[79] the Supreme Court of Louisiana found that the royalty interest is, in fact, entitled to share in those proceeds.

In *Frey*, Amoco had settled a take-or-pay claim against its pipeline purchaser, Columbia Gas Transmission Corp., but did not pass on any of the proceeds to the lessors as royalties.[80] The lessors sued Amoco, claiming underpayment of royalties.[81] The trial court found for Amoco, citing *Diamond Shamrock Exploration Co. v. Hodel,*[82] probably "the most cited case holding that royalty owners are *not entitled to share* in these take or pay settlements."[83] Frey appealed to the United States Court of Appeals for the Fifth Circuit which reversed, stating that "take-or-pay payments are part of the 'amount realized' from the sale of gas under the Lease, and thus such payments, received by the lessee in settlement of the take-or-pay dispute with its pipeline purchaser for gas not taken, are subject to the lessor's royalty."[84] On petition for rehearing, the Fifth Circuit withdrew the portion of the opinion relating to the take-or-pay settlement and certified the question to the Louisiana Supreme Court.[85]

The Louisiana Supreme Court agreed with the circuit court, which had "determined 'it would be contrary to the nature of the Lease as a *cooperative venture* to allow a benefit by any name that is attributable to the gas under the leased premises to inure exclusively to the lessee.'"[86] Addressing the take-or-pay issue, the court stated:

> Accordingly we look not at the parties' intent to provide expressly for take-or-pay payments, but rather at the parties general intent in

74. *See id.*
75. *See id.*
76. *See id.* n.73.
77. *See id.* at 51-52.
78. *See id.* at 52.
79. 603 So.2d 166 (La. 1992).
80. *See id.* at 169.
81. *See id.*
82. 853 F.2d 1159 (5th Cir. 1988).
83. SHADE, *supra* note 70, at 51.
84. *Frey*, 603 So.2d at 170.
85. *See id.*
86. *Id.* at 170 (quoting Frey v. Amoco Prod. Co., 943 F.2d 578 (5th Cir. 1991)) (emphasis added).

> entering an oil and gas lease, viz., the lessor supplies the land and the lessee the capital and expertise necessary to develop the land for the mutual benefit of both parties. In this manner the royalty clause is given an expansive reading, reflecting the mutuality of objectives and sharing of benefits inherent in the lessee-lessor relationship.[87]

The court found that, under the cooperative venture view of the relationship between the working and royalty interest, the royalty interest was entitled to share in take-or-pay settlements.[88] It expressly avoided deciding whether recoupable and nonrecoupable take-or-pay payments should be distinguished.[89] But this is an important distinction. With recoupable payments, there will likely be production at some point in the future, and a royalty will be paid based upon the actual proceeds realized by the working interest. A nonrecoupable payment, in theory, is not related to any identifiable production of natural gas, now or in the future. But the reality is it may be a part of a negotiated settlement where the future price of gas delivered is lowered in return.[90] This is a situation where the concept of constructive production could be applied.[91] While no actual production has occurred, the amount realized by the working interest relates to circumstances, which are tantamount to production. Clearly, the royalty interest will realize a smaller royalty in the future due to the negotiated price resulting from the nonrecoupable take-or-pay settlement in that case.

B. *The Plain Meaning Rule – Texas*

1. *Texas Oil and Gas Corp. v. Vela*

The case establishing the "market price at the wellhead" rule in Texas is *Texas Oil and Gas Corp. v. Vela*.[92] In *Vela*, the case involved a gas lease executed in 1933, covering 1,500 acres of land in Zapata County.[93] The lease included a typical royalty clause that required

87. *Id.* at 172-73 (emphasis added).

88. *See id.* at 182.

89. *See id.* A recoupable payment would be one where the pipeline could receive gas at a later date, without charge, up to the amount already paid under the take-or-pay provision (i.e. the amount paid for *not* taking the gas previously). *See* WILLIAMS & MEYERS, *supra* note 7, at 898. A recoupable payment affects the royalty interest only to the extent of the time value of money if a royalty is paid when the recoupment occurs, since the lessee had received payment when the previous take-or-pay payment was made. A nonrecoupable payment would not be specifically tied to any particular sales volume upon which the royalty would normally be based. *See id.* at 704.

90. This is the situation in *Condra v. Quinoco,* 954 S.W.2d 68 (Tex. App.—San Antonio 1997, writ denied) discussed in Part II. B. 5., *infra.*

91. See discussion *infra* Part III of constructive production as it relates to the cooperative venture. Simply stated, constructive production should be inferred whenever the royalty interest's rights in the underlying reserves have been impacted regardless of whether actual physical production has occurred.

92. 429 S.W.2d 866, 868 (Tex. 1968).

93. *See id.*

the lessee to "pay to lessor, as royalty for gas from each well where gas only is found, while the same is being sold or used off of the premises, one-eighth of the *market price* at the wells of the amount so sold or used."[94] The lessors sued for additional royalties some thirty years later when the market price of the gas had gone up.[95] The trial court held for the plaintiffs, ordering Texas Oil and Gas Corp. to pay additional royalties to the Velas.[96] The appeals court affirmed, and the Texas Supreme Court accepted the case for review.

At the time of the original lease, there was only one purchaser available, United Gas Public Service Company, which had built the pipeline to the producing gas wells.[97] The court noted that "United was the only commercial purchaser of gas in the field. The operators could market their gas only on a 'life of the lease' basis, and the price stipulated is the only price that could be obtained at that time."[98] In finding for the Velas, the court stated:

> It is clear then that the parties knew how to, and did, provide for royalties payable in kind, 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.[99]

The court recognized that the parties could have provided for royalties in-kind.[100] It then proceeded to ignore the implication that no in-kind royalties were provided for. That is, the parties did not intend to market the royalty share separately. The Velas did not sell their share of production at the market price;[101] all of the production was sold by the lessee at the long-term contract price.[102] It is unlikely that an oil and gas company intended to include in a gas lease that the royalty interest was entitled to a higher price than the producer could obtain under the circumstances.[103] The court's interpretation of the "market

94. *Id.* (emphasis added).
95. *See id.*
96. *See id.*
97. *See id.* at 870.
98. *Id.*
99. *Id.* at 871 (emphasis added).
100. In-kind royalties are royalties paid out in actual production. *See* WILLIAMS & MEYERS, *supra* note 7, at 952. The royalty interest receives its actual share of production and finds its own buyer. In that situation, the royalty interest could, in fact, sell its share at a price different from the long-term contract price realized by the working interest.
101. *See Vela*, 429 S.W.2d 866, 868 (Tex. 1968).
102. *See id.*
103. Producers could not reasonably be expected to agree to pay market prices on an eighth or more of production considering the large swings in oil and gas prices over

price" term results, in effect, in Texas Oil and Gas Corp. purchasing the royalty interest's production at the higher market price, then reselling it at the lower long-term contract price. That "plain meaning" interpretation of the term results in a lease agreement lessees would not have been likely to sign, much less author. The cooperative venture approach would seem to result in a more equitable treatment of both parties under the circumstances.

2. *Exxon Corp. v. Middleton*

Another well-known Texas case where the plain meaning rule was invoked is *Exxon Corp. v. Middleton.*[104] In this case, Exxon had entered into oil and gas leases with Middleton and others between 1933 and 1935.[105] The royalty clauses in the leases stated that royalties:

> on gas . . . produced from said land and 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 so sold *at the wells* the royalties shall be one-eighth of the amount realized from such sale.[106]

Some of the gas produced was processed at Exxon's plant which was located in the Anahuac Field where the wells were located but not on the actual lease.[107] Exxon argued that the sales should be considered *on the premises* with the royalty based on the amount realized.[108] Middleton argued that the Exxon plant is not located on the leased premises, and, therefore, the royalty should be based on market price, not the price realized by Exxon.[109] Exxon relied on *Butler v. Exxon Corp.*,[110] in which "at the well" was interpreted to mean anywhere in the vicinity of the field.[111] The court disapproved of the *Butler* interpretation of the clause and held that the sales at the tailgate of the plant[112] should be interpreted as taking place *off the premises.*[113] Under the Middleton leases, that would entitle Middleton to royalties

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the history of the industry if they were not realizing those prices on the sale. In this particular case, if the market price had risen another $.05 to $.184 per Mcf, the lessee would actually lose money on every Mcf produced after paying the royalty. While another established canon of construction is to hold ambiguities against the party creating the ambiguities, application of that canon in these cases seems to overwhelm both the intent of the parties and common sense. *See* Hitson v. Gilman, 220 S.W.2d 140, 144 (Tex. Civ. App.—Fort Worth, 1920).

104. 613 S.W.2d 240 (Tex. 1981).

105. *See id.* at 241.

106. *Id.* at 241-42 (emphasis added).

107. *See id.* at 242.

108. *See id.*

109. *See id.*

110. 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

111. *Exxon*, 613 S.W.2d at 243-44.

112. "At the tailgate of the plant" simply means that the gas is sold after it has been processed by the plant, a process that removes hydrocarbon liquids such as propane from the gas for sale as a separate product. *See* WILLIAMS & MEYERS, *supra* note 7, at 1068.

113. *See Exxon*, 613 S.W.2d at 244.

on the market value of the gas rather than the amount realized by Exxon.

This decision appears to be in keeping with the plain meaning rule as adopted in *Vela*. The troublesome aspect of the decision is the fact that the "market value" term used with respect to sales off the premises was written into the leases some 35 years prior to *Vela.* Common sense would seem to tell us that the term was not included because Exxon wanted to be sure Middleton received market price for sales off the premises, somehow distinguishing between those sales and sales at the well. There is simply no business reason for Exxon to have done so. The more obvious reason for inclusion of the term is to make clear to the royalty interest that it would be responsible for its share of any processing and transportation costs incurred to get the gas from the well to the ultimate purchaser in a salable form. While the royalty is not responsible for the cost of production, it is responsible for those types of post-production costs.[114] "Market value at the well" more likely was intended to mean the sale price less post-production costs.[115]

3. *Heritage Resources, Inc. v. NationsBank*

In a curious and widely criticized decision in 1996, *Heritage Resources, Inc. v. NationsBank,*[116]the Texas Supreme Court used the plain meaning rule to find that, even though the lease stated clearly that the royalty interest was not required to pay its share of the cost of transportation and related expenses, the plain meaning interpretation of the lease was that the royalty owner was, in fact, required to pay those costs.[117] In *Heritage*, NationsBank was the trustee for royalty owners of leases in which Heritage was the lessee. The royalty clauses in the three leases at issue had similar wording. One such representative clause stated:

> [T]he royalties to be paid Lessor are . . . (b) on gas . . . sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the well of 1/5 of the gas so sold or used . . . provided, however, *that there shall be no deductions* from the value of the Lessor's royalty by reason of any required process-

114. See, *e.g.*, Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118, 122 (Tex. 1996) (noting that royalties are subject to post production cost but not cost of production).

115. *See id.* For example, if the gas were sold for $2.00 per Mcf at the plant tailgate, including liquids, and the cost to transport and process the gas to that point were $.25 per Mcf, then the market price *at the wellhead* would be $1.75 per Mcf. The royalty would be based on $1.75 per Mcf, not $2.00. It seems that the key terms are "at the well" when assessing the intent of the parties.

116. 939 S.W.2d 118 (Tex. 1996).

117. *See id.*

ing, dehydration, compression, *transportation* or other matter to market such gas.[118]

NationsBank noticed that Heritage was, in fact, deducting transportation costs from the royalty share and sued to recover.[119] In overruling the court of appeals holding for NationsBank, the Texas Supreme Court relied on a definition of "market value at the well" which "involves subtracting reasonable post-production marketing costs from the market value at the point of sale."[120] The court held that the post-production clause was "surplusage as a matter of law."[121] Because that definition of market value at the well was inconsistent with the "no deductions" part of the royalty clause, the court held that Heritage could deduct transportation costs despite the express language to the contrary in the lease.

It is beyond the scope of this comment to address the apparent problems with the *Heritage* decision. It is not a case where the cooperative venture rule would result in a better decision because the dispute involved express terms of the lease which would override the cooperative venture rule. It does, however, serve as an example of the anomalies that can result from application of the plain meaning rule.

4. *TransAmerican Natural Gas Corp. v. Finkelstein*

The Texas Supreme Court has not yet ruled on whether the royalty interest is entitled to share in take-or-pay settlements. One court of appeals decision addressing the issue is *TransAmerican Natural Gas Corp. v. Finkelstein.*[122] In *Finkelstein*, TransAmerican assigned to Finkelstein a one-sixteenth overriding royalty interest[123] in any properties that Finkelstein acquired for TransAmerican.[124] Finkelstein was required to sell his share of the gas through TransAmerican under a gas purchase agreement.[125] TransAmerican entered into a long-term gas purchase contract with El Paso Natural Gas ("El Paso"), a large pipeline and utility, requiring El Paso to take all of the gas produced from a field in which TransAmerican (and Finkelstein, through its association with TransAmerican) held mineral interests or pay eighty percent of the amount not taken.[126] El Paso received a five-year recoupment

118. *Id.* at 120 (emphasis added).
119. *See id.*
120. *Id.* at 122. This is the definition the author suggests should have been inferred by the court in *Middleton* supra Part II. B. 2.
121. *Id.* at 123.
122. 933 S.W.2d 591 (Tex. App.—San Antonio 1996, writ denied)
123. As noted by the *Finkelstein* court, "[A]n overriding royalty is an interest carved out of, and constituting a part of, the working interest created by an oil and gas lease. *Id.* at 594, n.1 (citing Gruss v. Cummins, 329 S.W.2d 496, 501 (Tex. Civ. App.—El Paso 1959, writ ref'd n.r.e.)).
124. *See id.* at 593-94.
125. *See id.* at 594.
126. *See id.*

right entitling it to take gas it had paid for previously under the "pay" provision of the take-or-pay contract.[127]

In 1983, and in response to the market conditions discussed supra in Part I. A. 4., El Paso "filed a declaratory judgment action seeking to avoid the take-or-pay provision of its gas purchase contract with TransAmerican. TransAmerican counterclaimed for underpayment of gas and for breach of the take-or-pay provision."[128] Also in 1983, TransAmerican filed for bankruptcy and, in 1987, settled Finkelstein's claims for unpaid royalties and breach of the gas purchase agreement.[129] In 1990, TransAmerican and El Paso settled their claims for cash and property valued at $360 million to be paid to TransAmerican.[130] Included in the settlement was termination of El Paso's recoupment of make-up rights.[131] TransAmerican had paid Finkelstein royalties based on the spot market price of gas sold during the period from the settlement between TransAmerican and Finkelstein up to the date that the El Paso settlement effectively terminated Finkelstein's interest in the properties involved.[132] Once again, to simplify, TransAmerican realized at least part of the benefit of the take-or-pay contract price through the settlement reached with El Paso but only paid Finkelstein his royalty based on the lower spot market prices received on the actual sale of the gas. TransAmerican refused to pass any of the El Paso settlement on to Finkelstein, who sued for the difference between the royalty based on the spot price during that period and the take-or-pay contract price.[133] The trial court held for Finkelstein and awarded approximately $8 million in actual damages and another $4.5 million in attorneys' fees.[134] TransAmerican appealed.[135]

With respect to Finkelstein's right to receive a royalty, the court of appeals pointed to the plain meaning rule as established in *Vela* and further defined in *NationsBank*.[136] The court stated "Finkelstein's lease is tied to production. By this language, Finkelstein unambiguously limited his right to royalty payments from gas actually extracted from the land."[137] The court was not persuaded by Finkelstein's argument that the termination of El Paso's recoupment rights should entitle him to receive a royalty on the settlement proceeds.[138] The court noted that $536 million of the original court award to TransAmerican

127. *See id.* El Paso would then pay the difference between the take-or-pay payment and the delivery price. *See id.*
128. *Id.*
129. *See id.*
130. *See id.*
131. *See id.*
132. *See id.* at 594-95.
133. *See id.*
134. *See id.* at 595.
135. *See id.*
136. *See id.* at 597.
137. *Id.* at 598 (footnote omitted).
138. *See id.* at 599.

prior to settlement with El Paso was for repudiation damages for the period when El Paso took no gas and, therefore, there was no royalty due on gas not taken.[139] That is, the repudiation damages were to recompense TransAmerican for El Paso's failure to meet its "pay" obligation under the contract when it did not "take" the gas, not for actual production sold to El Paso. But it seems that the substance of what occurred was TransAmerican effectively received something above the spot market price on which it paid Finkelstein's royalty. In keeping with the cooperative venture model argued for in this Comment, this would be a situation where the take-or-pay settlement proceeds can be so closely associated with the royalty interest's rights in the underlying reserves that constructive production should be inferred. TransAmerican has an implied duty to obtain the highest reasonable price and has done so with the El Paso contract. Under the cooperative venture view of the implied duty to market, TransAmerican should not be held liable to Finkelstein for entering into a long-term contract if the market price goes up subsequently. Conversely, it seems only fair that Finkelstein should participate in *any* proceeds resulting from that long-term contract.

5. *Condra v. Quinoco*

In a 1997 San Antonio Court of Appeals case, *Condra v. Quinoco*,[140] the court heard a case involving a royalty owner's claim to part of a take-or-pay settlement. In *Condra*, the lessee, Quinoco, had entered into a long-term gas contract with El Paso which included a take-or-pay clause. The contract called for El Paso to pay the federally-regulated rate of $6.32 per unit[141] versus the spot price of $1.20 per unit. El Paso refused to take gas under the contract for a four year period, and Quinoco filed suit.[142] Ultimately, El Paso and Quinoco settled. Under the terms of the settlement agreement, El Paso was to pay Quinoco a recoupable payment of $3.5 million and a nonrecoupable payment of $2.3 million.[143] According to the court:

> [T]he recoupable payment was a prepayment for approximately one billion cubic feet of gas to be delivered in the future. The nonrecoupable payment was consideration for certain amendments to the Gas Purchase Agreement and settlement of other claims, one

139. *See id.*

140. 954 S.W.2d 68 (Tex. App.—San Antonio 1997, writ denied).

141. The unit being MMBTU, or Million British Thermal Units, which is a measure of the heat content in gas. *See* WILLIAMS & MEYERS, *supra* note 7, at 225. This measurement is generally upon which the price is based. Telephone Interview with Steve Estes, Gas Marketing Manager of Union Pacific Resources, Fort Worth, Tex. (April 14, 1999). One Mcf of gas will generally have an MMBTU content of plus or minus 1000. *See, e.g.*, WILLIAMS & MEYERS, *supra* note 7, at 225.

142. Condra v. Quinico Petroleum, Inc., 954 S.W.2d 68 (Tex. App.—San Antonio 1997)

143. *See id.* at 70.

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> of which was identified as El Paso's failure to take rateably [sic] from the appellees' wells.[144]

The contract was amended to, among other provisions, remove the pricing and take-or-pay provisions.[145]

Quinoco refused to share any of the settlement with the royalty owner, Condra, who then filed suit. The court of appeals held for Quinoco, finding that the settlement did not represent proceeds on production. The majority opinion relied heavily on *TransAmerican Natural Gas Corp. V. Finkelstein.*[146] In a dissenting opinion in *Quinoco*, Justice Rickhoff quotes *Williamson v. Elf Acquitaine*,[147] a Mississippi district court decision holding for the royalty owner under similar circumstances, stating:

> [T]he court held that "a court's finding that nonrecoupable settlements are indeed royalty-bearing, based on the fact that production has occurred, is consistent with the Texas court's literal interpretations of the lease language." The court noted that this interpretation of the lease takes into account "the practical realities of the gas market" and infuses "an examination of the equities of settlements within an interpretation of the lease language itself."[148]

The effect of the nonrecoupable payment to Quinoco is to adjust the price ultimately realized on the sale of gas. The working interest reaps the benefit of the settlement and effectively prevents the royalty interest from receiving full proceeds on the sale. The court implicitly states that production has occurred,[149] but refuses to relate the settlement to that production.

The court in *Condra* takes a form over substance position in finding that the take-or-pay settlement is not tied to actual production. For the working interest to receive a higher price for gas than the royalty interest on the same production would clearly be inconsistent with the royalty clause.[150] As demonstrated in *Condra*, the settlements, in substance, are clearly linked to the lessor's rights in the underlying reserves in some cases, and the court should adopt a standard of constructive production to protect the lessor's interest. One Texas court

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144. *Id.*

145. *See id.*

146. 933 S.W.2d 591 (Tex. App.—San Antonio 1996, writ denied).

147. 925 F. Supp. 1163 (N.D. Miss. 1996) This case has been reversed by the 5th Circuit in *Williamson v. Elf Acquitaine* 98 F.3d 546 (5th Cir. 1998). However, reference here is merely to help frame the argument.

148. *Condra*, 954 S.W.2d at 74 (quoting *Williamson*, 925 F. Supp. at 1170 (N.D. Miss. 1996)).

149. *See id.* at 70. The nonrecoupable payment, like in the *Finkelstein* case, effectively results in Quinoco being paid a higher price for production not taken by El Paso than what Condra's royalty is based on.

150. *See e.g.*, note 12, *supra.*

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has agreed with *Condra.*[151] The issue has not yet been decided by the Texas Supreme Court.

6. *Neel v. HECI*

In *Neel v. HECI Exploration Co.*,[152] the Austin Court of Appeals decided a case in which the working interest operator had been awarded monetary damages against AOP, an operator of an adjacent lease. AOP was accused of over production in violation of Texas Railroad Commission proration orders.[153] HECI Exploration Company (HECI) claimed that AOP had damaged the reservoir by its over production resulting in lost reserves for HECI.[154] HECI did not inform the Neel family, the lessors of the property involved, of the dispute, trial, or subsequent award levied against AOP.[155] When the Neels learned of it four years later, they sued HECI for their one-sixth royalty share of the award.[156]

The court noted that the Neels were entitled to one sixth of the oil produced.[157] However, it then referred to the earlier Texas case, *Rogers v. Osborn*,[158] to define production as "oil physically extracted from the ground, and, therefore, the Neels were not, as a matter of law, entitled to a share of HECI's recovery from AOP as a royalty."[159] The *Rogers* case simply did not define production in that way,[160] but regardless, the *Rogers* case involved an entirely different issue. In that case, the court was addressing whether production had actually occurred in order to hold a lease.[161] The actual *physical* extraction of the oil was the central issue in that case.[162] In *Neel*, the question before the court was not whether oil was physically extracted (AOP saw to it that it was not), the question was whether the Neels were

151. *See* Alameda Corp. v. TransAmerican Natural Gas Corp., No. 14-96-00044-CV (Tex. Civ. App.—Houston [14th Dist.], March 27, 1997, n.w.h.).

152. 942 S.W.2d 212 (Tex. App.—Austin 1997) *rev'd on other grounds,* 982 S.W.2d 881 (Tex. 1998). The Texas Supreme Court overruled the Austin Court of Appeals, holding that "there is no implied covenant that requires a lessee to give notice of its intent to sue an adjoining operator because such a duty is not necessary to effectuate the full purpose of the lease and is not clearly within the contemplation of the parties that they deemed it necessary to express it." *Id.* at 881-82. This decision is consistent with earlier Texas history of applying the plain meaning rule. Much of this Comment's analysis of the Austin Court of Appeals' decision is equally applicable.

153. Pro ratio orders are directives issued by the Texas Railroad Commission to set production allowances for specific leases in order to regulate statewide production of oil and gas reserves and protect adjacent leases. *See* WILLIAMS & MEYERS, *supra* note 7, at 1102.

154. *See Neel*, 942 S.W.2d at 215.

155. *See id.*

156. *See id.*

157. *See id* at 216.

158. 261 S.W.2d 311 (Tex. 1953).

159. *Neel*, 942 S.W.2d at 217.

160. *See Rogers*, 261 S.W.2d at 312. In *Rogers,* the court defined production as "marketable oil or gas." *See id.* (citing Garcia v. King, 164 S.W.2d 509 (Tex. 1942)).

161. *See id.*

162. *See id.*

entitled to a share of monetary damages relating to oil production which they now could never receive.[163] The court ultimately arrived at the conclusion that HECI owed the Neels an implied duty to inform them of the case under the theory of implied covenant to protect the lease.[164] The *Neel* court specifically rejected the theories of unjust enrichment and negligent misrepresentation.[165] While the end result of the decision appears correct,[166] the court again used a narrow definition of production to find that the Neels were not entitled to their royalty share under the royalty clause.

Clearly, the proceeds received by HECI from the litigation were based on the amount of reserves drained by AOP. The fact that the reserves did not actually exit through HECI's wellhead, but instead through AOP's, should not mean the Neels were not entitled to their share of the value of proceeds received by HECI. The reserves in which the Neels owned a royalty interest were removed from the reservoir, and HECI effectively was paid for those reserves. It is simply semantic hair-splitting for the court to find that actual production had not occurred. Under the cooperative venture model as defined in this comment, the court could have found that constructive production had occurred and awarded the Neels their royalty share without needing to refer to the implied covenants or unjust enrichment. The circumstances surrounding a drainage case seem to represent possibly the best example of circumstances equivalent to actual production where the concept of constructive production could be applied.

III. CONSTRUCTIVE PRODUCTION AND ACTIVITIES OUTSIDE OF THE COOPERATIVE VENTURE

A. *Constructive Production*

As noted in the example provided at footnote 11 above, the typical royalty clause in a Texas oil and gas lease refers to a royalty due on oil or gas "produced and saved from said land." Many of the decisions discussed above where Texas courts have applied the plain meaning rule have included a holding that production has not occurred because physical extraction from the lease has not taken place. Under the cooperative venture model argued for in this Comment, Texas should expand the definition of constructive production. As noted in footnote 15 above, the term is typically used in the case of shut-in royalties where payment is made in lieu of actual production. It seems clear that there are circumstances where the royalty interest's rights in the underlying reserves have been affected even though actual physical extraction has not occurred. Drainage by an adjacent lease, as oc-

163. *See Neel*, 942 S.W.2d at 215.
164. *See id.* at 218.
165. *See id.*
166. And by implication, the Supreme Court's ruling does not appear to be correct.

curred in *Neel*, would be a clear example because the actual reserves have been lost. But even where only the price to be realized has been affected, as in the case of negotiated price changes involving non-recoupable take-or-pay settlements, it is clear that the royalty interest's rights in the reserves have been affected. Under the cooperative venture model, circumstances affecting the value of the royalty interest's rights in the reserves would trigger his right to participate in the proceeds, not just actual physical production.

B. *Other Activities*

However, there appear to be circumstances where the cooperative venture rule should be narrowly construed. Oil and gas companies participate in options and futures markets in order to hedge against price swings.[167] These transactions are sufficiently distinct from production and marketing of oil and gas that it would seem equitable to exclude the royalty interest from the gains, as well as the losses, of those transactions. For example, options contracts have no relationship to actual production of the company. They are, often by definition, contracts relating to production of *other* oil or gas purchased on a commodity exchange. They are virtually never settled in the actual transfer of oil or gas, and no ownership of existing reserves is required to enter into many of the contracts. There would be no practical way to assign gains and losses on those transactions to actual production carrying a royalty burden.

Another such activity would be transactions related to federal and state income taxes. The tax credits allowed for certain drilling activities[168] are realized as the underlying reserves are produced; however, the credit itself results from risks that the working interest bore alone. These credits are clearly associated with drilling activities for which the royalty interest has no obligation to participate. It would seem fair that they accrue only to the working interest. It is certainly possible that a tax credit could be provided for an activity that affects the royalty owner. An unlikely possibility might be a credit for *not* producing, similar to crop subsidies. This would clearly penalize the royalty interest if it were not permitted to share in the credit. But this Comment argues that an activity should meet the threshold of qualifying as constructive production in order to be deemed part of the cooperative venture. To do otherwise would make the rule unworkable and unfair to the working interest.

Conclusion

Texas courts appear to be going out of their way to ignore the substance of transactions involving royalty interests. In the situations de-

167. For example, one major independent exploration and production company financial audit client of the author hedged up to fifty percent of its following year production to lock in a more stable price.

168. For example, I.R.C. § 29 tax credits allowed for drilling coal seam gas wells.

scribed above, the courts have found that the royalty interest was entitled to a price at which the related production was not actually sold and refused to find that a royalty interest owner was entitled to share in proceeds, which in substance were clearly related to production at the well. It is simply inconsistent with the nature of oil and gas operations to entitle the royalty interest to a different price than the working interest realizes on the actual sale of the underlying reserves. The working interest is not *purchasing* the royalty interests share; it is *marketing* the royalty interests share. In order to ensure a consistent buyer, at times those marketing efforts include entering into long-term contracts, often at prices below spot prices. The royalty interest is entitled to market its share if it feels it can realize a higher price. In fact, some oil companies with royalty or override interests do just that.[169] To allow the royalty interest the higher of market price at the wellhead or actual proceeds would seem to shift all of the risk of price to the working interest.

Allowing the working interest to keep all proceeds on litigation and settlements where the proceeds relate to reserves owned by the royalty interest seems to be equally unfair. If the end result is that the working interest realized a higher price than the royalty interest on the same reserves, then, regardless of the steps involved to arrive at that point, the royalty owner has not been treated consistently with the lease agreement.

The adoption of the *Vela* plain meaning rule, combined with some suspect interpretations as to what was the plain meaning in given cases, seem to have resulted in decisions which have been unfair to either the working or royalty interest. The plain meaning rule unnecessarily puts the working interest and royalty interest in conflicting positions and encourages litigation. The cooperative venture rule followed in Oklahoma, Arkansas, and Louisiana, three states with significant oil and gas industries, appears to be more representative of the substance of the agreements and nature of the industry. It is clearly more fair to all of the parties involved.

The Texas Supreme Court should reverse years of dubious decisions by adopting the cooperative venture approach. To provide a fairer and more practical application of the rule, the court should expand the definition of constructive production to cover circumstances where events equivalent to production have occurred but limit the cooperative venture to actual and constructive production. Activities clearly not related to the royalty interest's share of the underlying reserves should be excluded from the cooperative venture.

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169. The author has worked with several companies who held royalty interests in wells operated by the author's employer where the royalty interest took its share in-kind in order to market its own oil.

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