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GAS ROYALTY PROVISIONS AND THE RIGHTS OF LESSORS AND LESSEES WITH RESPECT TO SALE OF GAS

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IT IS MY FEELING that some of you may have the idea that this subject is interesting only from an academic standpoint. To the contrary, it is my opinion that the construction of the gas royalty provisions in oil and gas leases, and the rights of lessors and lessees with respect to the sale of gas thereunder, will afford some of the most practical problems that an oil and gas lawyer in this northwestern area will consider in the next twenty years. It is true that we have not yet discovered any great gas reserves in this area, but this development is inevitable with the passage of time, and any careful lawyer should have a knowledge of the meaning and net effect of the gas royalty provisions contained in an oil and gas lease to which his client is a party — considerations which are not now fully appreciated or understood by too many of the oil and gas lawyers in this country.

There are certain basic differences between the usual oil and gas lease clause providing for oil royalties and the lease provisions prescribing the manner of payment of royalties on the production of gas. The customary oil royalty clause reads substantially as follows:

> "On oil and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected."

Subject to certain changes in phraseology, the customary gas royalty provisions of a lease read:

> "On gas including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale; and (c) if at any time while there is a gas well or wells on the above land (and for the purposes of this clause (c) the term 'gas well' shall include wells capable of producing natural gas, condensate, distillate or any gaseous substance and wells classified as gas wells by any governmental authority)

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such well or wells are shut in, and if this lease is not continued in force by some other provision hereof, then it shall nevertheless continue in force for a period of ninety (90) days from the date such well or wells are shut in, and before the expiration of any such ninety-day (90-day) period, lessee or any assignee hereunder may pay or tender an advance annual royalty equal to the amount of delay rentals provided for in this lease for the acreage then held under this lease by the party making such payment or tender, and if such payment or tender is made, this lease shall continue in force and it shall be considered that gas is being produced from the leased premises in paying quantities within the meaning of paragraph 2 hereof for one (1) year from the date such well or wells are shut in, and in like manner subsequent advance annual royalty payments may be made or tendered and this lease shall continue in force and it will be considered that gas is being produced from the leased premises in paying quantities within the meaning of said paragraph 2 during any annual period for which such royalty is so paid or tendered; * * *"

Under the above quoted oil royalty clause, the payment of such royalty to the lessor is provided to be in kind, that is, by delivery to the lessor or his credit of 1/8th of the oil produced and saved from the leased land, and, therefore, the lessor is said to have reserved a vested royalty interest in the oil which is excepted from the grant.[1]

However, under the above quoted gas royalty clause, the full 8/8ths interest in the gas produced under the lease vests in the lessee, and the royalty interest of the lessor is payable only in money.[2]

In *Tidewater Associated Oil Company v. Clemens*,[3] the court said:

"Appellee concedes that by the grant in the lease ownership and title to all the gas produced from the land passed to apellant. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 254 S.W. 290, 29 A.L.R. 566. Appellee further concedes that appelant's agreement to pay the rentals stipulated in the royalty provisions of the lease is a personal obligation on the part of appellant, a promise to pay a specific price for a thing—

1. A leading case, cited numerous times with approval by the State and Federal courts, is Hager v. States, 116 Tex. 453, 294 S.W. 835. See also Sneed, *Value of Leessor's Share of Production Where Gas Only Is Produced*, 25 Tex. Law Rev. 641 (1947).

2. Humble Oil and Refining Co. v. Poe, 29 S.W.2d 1019 (Tex. Comm. App., 1930); Magnolia Petroleum Co. v. Stroud, 3 S.W.2d 465 (T.C.A., 1927, err. Dism.); Wall v. United Gas Public Service Co., 178 La. 908, 152 So. 561 (1934); Sneed, *supra* note 1, at 641, and numerous other authorities. See also Magnolia Petroleum Co. v. Connellee 11 S.W.2d 158 (Tex. Comm. App. 1928) wherein the court held that under an oil and gas lease, which expressly provided for the payment of a fixed sum per gas well per year, all of the casinghead gas or dry gas produced under the lease was conveyed to and became the property of the leassee.

3. 123 S.W.2d 780 (T. C. A., 1938).

gas—already conveyed to and owned by appellant. Reynolds v. McMan Oil & Gas Co., Tex. Com. App., 11 S.W. 2d 778. And it is not disputed but that appellant's ownership of all the gas comprehends ownership of every constituent element thereof and that he had the right to sell the same or any part thereof, charged only with appellee's right to demand and appellant's corresponding obligation to pay the agreed rental on the gas sold which in this is the '1/8th of the market price at the wells of the amount sold.' Magnolia Petroleum Co. v. Connellee, Tex. Com. App., 11 S.W. 2d 158."

At this point, it should be noted that a majority of my references and authorities come from Texas sources, but the rules and principles of law stated therein are general rules of construction and should receive universal application. In connection therewith, I have made a diligent search and have been unable to find any authorities announced by the courts in this area to the contrary.

We have heretofore indicated the customary gas royalty clause contained in perhaps a majority of the lease forms now being used in the area. Naturally, there are variations in the wording of this clause as reflected in a number of the current lease forms,[4] but regardless of the phraseology, the same standards of "market price", "market value at the mouth of the well", "amount realized from the sale thereof", and "proceeds from the sale thereof" ap-

4. Several typical gas royalty provisions in oil and gas leases are:

(1) "On gas (including casinghead gas and other vapors) produced from said land and sold or used off the leased premises or in the manufacture of gasoline or other products, the current market price at the wells of one-eighth (⅛) of the gas so sold or used."

(2) "Lessee shall pay lessor, as royalty, one-eighth of the proceeds from the sale of the gas, as such, for gas from wells where gas only is found, and where not sold shall pay Fifty Dollars ($50.00) per annum "as royalty from each such well, and while such royalty is so paid such well shall be held to be a producing well under paragraph two hereof. The lessor shall have gas free of charge from any gas well on the leased premises for stoves and inside lights in the principal dwelling house on said land by making his own connections with the well, the use of said gas to be at lessor's sole risk and expense. Lessee shall pay to lessor for gas produced from any oil well and used by lessee for the manufacture of gasoline, or any other product, as royalty, one-eighth (⅛) of the market value of such gas. If said gas is sold by lessee, then, as royalty, one-eighth of the proceeds of the sale thereof."

(3) "To pay lessor one-eighth (⅛) of the market value at the well for gas from each well where gas only is found and used off the premises, and lessor to have gas free of cost from any such well for all stoves and all inside lights in the principal dwelling house on such land during the same time by making his own connections with the well at his own risk and expense.

"To pay lessor one-eighth (⅛) of the market value at the well for gas produced from any oil well and used off the premises, or for the manufacture of casinghead gasoline or dry commercial gas."

(4) "To pay the lessor one-eighth, at the market price at the well for the gas so used, for the gas from each well where gas only is found, while the same is being used off the premises, and lessor to have gas free of cost from any such well for all stoves and all inside lights in the principal dwelling house on said land during the same time by making his own connections with the wells as his own risk and expense.

"To pay lessor for gas produced from any oil well and used off the premises or for the manufacture of casinghead gasoline, one-eighth, at the market price at the well for the gas so used, for the time during which such gas shall be used, said payments to be made monthly."

pear in some form in nearly all leases as the criteria for the determination of the royalty to be paid the lessor, and under any of these standards, a computation by the lessee is required in order to translate actual gas production figures into money payments. It is therefore important both to the lessor and the lessee that the mechanics and factors affecting this computation be understood when the lease is executed and accepted by them.

Due to its nature and make-up, the gas industry presents a problem even more complex than does the oil industry. As has been pointed out, "this additional complexity is, of course, due to the physical properties of the gas itself. Because gas is incapable of being stored in large quantities, its utilization must always equal production, excepting wastage. Places of utilization can be reached only by means of expensive pipe lines, thus limiting stringently the free exchange of the commodity.[5] Gas of a given quality now being utilized for the manufacture of carbon black cannot effectively compete with gas of the same quality being used for light and fuel purposes. Since the consumers for light and fuel purposes pay more per cubic foot for their gas than do consumers for carbon black purposes, the value of a given quantity of gas at a given point is determined by the use made of the gas, and one quantity of gas need not have the same value unless they are similarly utilized. This value differential cannot be equalized by the law of supply and demand forcing a surplus of gas into the consumer market paying the most for the gas. Manifestly, such equalization is physically and economically impossible. An appreciation of these physical and economic factors is essential to a proper understanding of the problems recently before the courts."[6]

It thus appears that such general standards as market price and market value, as hereinbefore referred to, are required for the determination of the amount of royalties to be paid on gas production under varying and sometimes unforeseen situations. Experience has proven that it is not practicable to fix a price on which to base the payment of these gas royalties. During the development of the Carthage Gas Field in East Texas approximately ten years ago, one gas royalty clause then currently in use provided for the payment of the royalty owner's share of the gas at the rate of 3¢ per thousand cubic feet.[7] With the construction

5. Sneed, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 Tex. Law Rev. 641 n. 7 (1947).
6. Sneed, *supra* at pages 641 and 642.
7. One such clause read: "To pay Lessor for all gas (whether casinghead or otherwise) produced from said land and sold or utilized off the premises or used in the

following the close of World War II of the trans-continental pipe lines carrying gas to distant consumer markets, an increased demand for gas was created which naturally resulted in raising the price paid for gas in the Carthage Field, and as a result, it was not uncommon for a landowner to receive the payment of gas royalties from one company calculated on the basis of 3¢ per thousand cubic feet, and at the same time to receive a gas royalty from another company under a market value lease calculated on the basis of the prevailing market price of 5¢ per thousand cubic feet.[8] In addition, the gas royalty computed on the 3¢ basis was in some cases further reduced by the unfavorable provisions of the lease, from the lessor's standpoint, as to the pressure and temperature at which the gas was to be measured. It should be remembered that Boyle's Law may vitally affect the amount of the royalty paid to a lessor whenever the lease terms provide for the measurement of the gas upon a given pressure and temperature basis.[9]

It therefore appears that a more flexible standard for the determination of the payment of gas royalties is desirable, and it is perhaps for this reason that the more general terms of "market value" and "market price" have been included in the gas royalty clauses hereinbefore mentioned. However, general as these terms may be, they are susceptible of definition and construction depending upon applicable production, marketing and other conditions. Mr. George Siefikin, speaking before the Fourth Annual Oil and Gas Institute at the Southwestern Legal Foundation, has summarized certain evidentiary rules with respect to the meaning of these terms as follows:[10]

"(1) 'Market price' and 'market value' of gas (or oil) at the well mean the price for which gas of the same quality is being sold under similar conditions and for comparable utilization purposes in the field, or, undoubtedly, in analogous fields.[11]

"(2) If the gas has a market value in the field for one purpose, but not for another—as where purchasers for gasoline ex-

manufacture of gasoline or other product therefrom, ⅛th of the value of such gas at the mouth of the well in its natural state (including gasoline, whether same be recovered by drips or through absorbtion plant or by any other process) calculated at the rate of three (3c) cents per 1,000 cubic feet, corrected to 2 lbs. above assumed atmospheric pressure of fourteen and seven tenths (14.7 lbs.) pounds per square inch."

8. This condition was only resolved when the operating companies *voluntarily* entered into amendments of existing leases which contained the fixed price of 3c, so as to provide for an increased royalty on gas production thereunder.

9. In this connection, Texas has recently enacted a gas measurement statute. Article 6066b, §2, Vernon's Revised Civil Statutes of Texas.

10. Siefkin, Rights of Lessor and Lessee With Respect To Sale Of Gas and As To Gas Royalty Provisions, *Fourth Annual Institute on Oil and Gas Law and Taxation*, Southwestern Legal Foundation, page 181, 185-187.

11. Siefkin, *Id.*, n. 12.

traction are available, but no sales can be made to pipe lines for fuel and light distribution—the market value for the saleable use controls (even though the purchaser may in fact devote it to a different use).[12]

"(3) In the absence of well head sales in the field (which is the common situation), market price at the well is established by proving market price paid elsewhere in the field, less the cost of transporation to the available market.[13]

"(4) What pipe line purchasers pay for gas under long term 'dedication' contracts, involving numerous considerations not present in well head sales to, say, gasoline extractors, is irrelevant and inadmissible to prove market vaule at the well.[14] However, if expert testimony is adduced which appraises these collateral 'considerations' and which, accordingly, arrives at a well head evaluation, then evidence of pipe line purchase prices—as analyzed by the expert witnesses—is competent.[15]

"(5) If, but only if, the lessor first clearly establishes the absence of 'market value' he may then attempt to prove 'intrinsic' (or 'real', 'actual', or 'reasonable') value of his gas at the well, by any and all available means, and insist that his royalties be computed on that basis.[16]

While it appears that "market value" and "market price" have substantially the same meaning as will be hereinafter mentioned, there is a difference of opinion as to whether there is a distinction to be drawn between such terms and "proceeds" or "net proceeds". Mr. Sneed believes that the term "proceeds" means something different from "market price" or "market value",[17] while Mr. Siefkin has taken the position that for all practical effect, the terms "market price", "market value" and "proceeds" result in the application of the same standard, that is, under any standard, the royalty is predicated on the market value at the well head, irrespective of the price of sale.[18] It is true that there does not appear to be any real distinction between "market value" and "market price"

12. Siefkin, *Id.*, n. 13.
13. Siefkin, *Id.*, n. 14.
14. Siefkin, *Id.*, n. 15.
15. Siefkin, *Id.*, n. 16.
16. Siefkin, *Id.*, n. 17.
17. Sneed, *supra* note 5, at 655, citing Adams v. Petroleum Co., 205 Cal. 221, 270 Pac. 668 (1928), but calling attention to O'Neal v. Union Producing Co., 153 F.2d 157 (5th Cir. 1946), *cert. denied*, 329 U.S. 715 (1946), where the royalty was "one-eighth part of net proceeds at prevailing market price at well" and the court held that the market price was the proper standard.
18. Siefkin, *supra* note 10, at 214, citing E. G. Kretni Development Co. v. Consolidated Oil Corporation, 74 F.2d 497 (10th Cir. 1934) ("proceeds"); Phillips Petroleum Co. v. Ochsner, 146 F.2d 138 (5th Cir. 1944) ("gross proceeds"); Warfield Natural Gas Co. v. Allen, 261 Ky. 840, 88 S.W.2d 989, 991 (1935) ("gross proceeds" held to mean market value at the well); *cf.* O'Neal v. Union Producing Co., 57 F. Supp. 440 (W.D.La. 1944), affirmed 153 F.2d 157 (5th Cir. 1946) ("net proceeds"); Saulsbury Oil Co. v. Phillips Petroleum Co., 142 F.2d 27 (10th Cir. 1944) ("net proceeds").

with reference to a gas royalty clause,[19] but it is possible that under a given fact situation, a different result would be obtained if the applicable standard was "proceeds" or "net proceeds".[20] This difference would likewise exist where the standard was the "amount realized from such sale," and the amount of gas royalty paid thereunder might well be more or less than that paid a lessor on the basis of "market price" or "market value." It is suggested that if the lessor—lessee intent is to allow the lessor, as royalty, one-eighth of the proceeds from the sale of leased gas, the term "amount realized from such sale" should be incorporated in the lease. This standard is capable of definite ascertainment and will render unnecessary the somtimes complicated process of determining "market value" or "proceeds." Regardless of what standard is used, however, it appears to be well settled that the determination of such standard is a question of fact,[21] and whether sales of gas in the field, or evidence of prices paid for gas by pipe line companies, are admissible in evidence, as well as the weight to be given such evidence even if admitted, seems dependent in part, from an analysis of the reported decisions, upon the situation and equities in the particular action.

No one will question the fact that the ordinary gas royalty clause is general and somewhat ambiguous, but it is suggested, in view of the nature and complexity of the gas industry and the innumerable variables which affect the determination of the royalty to be paid on gas production, that elasticity is desirable. Regardless of other considerations, this clause is subject to being construed by the parties, or by the courts if necessary, with regard to the intention of the parties and the attending circumstances at the time of the

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19. Arkansas Natural Gas Co. v. Sartor, 78 F.2d 924 (5th Cir. 1935); Phillips Petroleum Co. v. Bynum, 155 F.2d 196 (5th Cir. 1946). These terms are defined in Bouvier's Law Dictionary, page 758—"Market Price . . . it means the price at which such articles are sold and purchased"; "Market Value. A price established by public sales, or sales in the way of ordinary business." See also Sartor v. United Gas Public Service Co., 84 F.2d 436 (5th Cir. 1936); Union Producing Co. v. Pardue, 117 F.2d 225 (5th Cir. 1941); Haynes v. Southwest Natural Gas Co., 123 F.2d 1011 (5th Cir. 1941); Sartor v. Arkansas Natural Gas Corp., 134 F.2d 433 (5th Cir. 1943). *But cf.* Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409 (5th Cir. 1944) where the court held that market price is not necessarily the same as market value. This decision has been criticized as being in conflict with the other decisions of the same court, *supra*, but it is believed that it can be reconciled.

20. Sneed, *supra* note 1, at 654. But see Siefkin, *supra* note 10, at 213 who, while stating that the distinction is literally correct, takes an opposite view, citing Phillips Petroleum Co. v. Ochsner, 146 F.2d 138 (5th Cir. 1934) and Phillips Petroleum Co. v. Record, 146 F.2d 485 (5th Cir. 1944).

21. Sartor v. Arkansas Natural Gas Corp., 321 U.S. 620 (1943); Hemler v. Union Producing Co., 134 F.2d 436 (5th Cir. 1943); Union Producing Co. v. Pardue, 117 F.2d 225 (5th Cir. 1941); Sneed, *supra* note 1, at 649.

execution of the lease, and perhaps the concern of some writers for the redrafting of this clause may not be warranted.[22]

As we have seen, there is granted to the lessee under the usual oil and gas lease the ownership and title to all of the gas produced from the leased land,[23] and the lessee has the right to sell such gas without the joinder or consent of the lessor for such price and on such conditions as the lessee may determine. Some may say that it is not fair to deny the lessor the opportunity to participate in the marketing of the gas, but actually this objection is seldom raised. While it is true that a gas purchase contract providing for the sale of gas does not always cover a large area, the fact that gas is ordinarily produced from gas production units usually results in a number of royalty owners participating in the payment of royalties from production under one contract. If the consent of all of these royalty owners was required before one gas purchase contract could be consummated, it is entirely possible that a contract would never be executed.

However, another problem is presented, in theory at least, when a lessee executes a gas purchase contract whereby he sells the gas produced under leases containing clauses similar to those hereinbefore mentioned. Let us assume that the lessee executes a gas purchase contract for a term of 25 years. The current price then being paid for gas in the field is 3¢ per thousand cubic feet, but because of the length of the contract commitment, the lessee obtains a contract price of 5¢ per thousand cubic feet. Thus the royalty owner is initially benefited by receiving payment of his royalty on the basis of a gas price higher than the market value in the field, but this situation is reversed when five years later, the market value in the field is 8¢ per thousand cubic feet. The lessor is entitled to the market value of his gas royalty under the lease, he is not a party to the gas purchase contract and is not bound thereby, and the question is whether or not he is entitled to payment of the difference between the contract price and the market value. It has been stated that when the gas purchase contract was excuted by the lessee in compliance with his obligation as a reasonable prudent operator to market the gas produced under the lease, the lessor could not legally complain of the economics resulting therefrom.[24] Further, there is authority for the proposition that the

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22. Siefkin, *supra* note 10, at 216; Sneed, *supra* note 1, at 656.
23. See authorities cited in note 2 *supra*.
24. Siefkin, *supra* note 10, at 188-191. Mr. Siefkin also indicates that the shoe fits both ways and that by reason of the long term contract, the lessor is insured against a price decline.

lessor accepts the terms of the contract by executing a division order with knowledge of the contract.[25] While it is true that the ordinary division order may be an agreement between the lessor and the lessee as one party, and the pipe line purchaser of the production as the other party, and is usually terminable at will by the lessor,[26] this situation can be resolved under any theory by including in the division order an express provision whereby the gas purchase contract is ratified.[27]

That part of the above quoted gas royalty clause providing for the payment of shut-in gas royalties has already been discussed by Professor Williams, and I will not further elaborate on the problems arising with respect thereto. It appears that these payments are in the nature of royalty, as distinguished from the delay rentals payable under an oil and gas lease, and the royalty owner is entitled to receive same in lieu of the other gas royalties provided in the lease.[28]

The pooling clause in an oil and gas lease is not included as a part of the royalty provisions, but it often materially affects the respective rights of the lessor and lessee with respect to gas production under or allocated to the lease. A typical clause of this type[29] usually grants to the lessee the right to pool or unitize the

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25. Union Producing Co. v. Driskell, 117 F.2d 229 (5th Cir. 1941); Indian Refining Co. v. Kellar, 203 Ky. 720, 263 S.W. 9 (1924); Simpson v. United Gas Pipe Line Co., 196 Miss. 356, 17 S.2d 200 (1944); Merrill, Covenants Implied In Oil and Gas Leases §85 (2d ed. 1940).

26. Mills & Willingham, Law of Oil & Gas §136 (1926); 3 Summers, Oil and Gas §590 (1938); Merrill, *op. cit. supra* note 25, §85 (1950 Supplement). These writers also suggest that the execution of a division order by the lessor should not affect the obligations of the lessee under the lease except as to matters of estoppel and the like created by the division order. See also Stanolind Oil & Gas Co. v. Terrell, 183 S.W.2d 743 (Tex. C. A. 1944); Phillips Petroleum Co. v. Williams, 158 F.2d 723 (5th Cir. 1947).

27. In Indian Refining Co. v. Kellar, 203 Ky. 720, 263 S.W. 9 (1924), the lessor was held to be bound by the lessee's long term contract by reason of the execution of a division order, which did not include an express ratification provision, apparently on the ground of an estoppel in pais. This result seems logically correct.

28. Morriss v. First Nat. Bank of Mission, 249 S.W.2d 269 (Tex. C.A. 1952). See also Walker, *Clauses in Oil and Gas Leases Providing for the Payment of an annual Sum As Royalty on a Non-Producing Gas Well*, 24 Tex. Law Rev. 478 (1946).

29. Lessee is hereby granted the right to pool or unitize this lease, the land covered by it or any part thereof with any other land, lease, leases, mineral estates or parts thereof for the production of oil, gas or any other minerals. Units pooled for oil hereunder shall not exceed forty (40) acres plus a tolerance of ten per cent (10%) thereof, and units pooled for gas hereunder shall not exceed six hundred forty (640) acres plus a tolerance of ten per cent (10%) thereof, provided that if any Federal or State law, Executive order, rule or regulation shall prescribe a spacing pattern for the development of the field or allocate a producing allowable on acreage per well, then any such units may embrace as much additional acreage as may be so prescribed or as may be used in such allocation or allowable. Lessee shall file written unit designations in the county in which the premises are located. Such units may be designated either before or after the completion of wells. Drilling operations and production on any part of the pooled acreage shall be treated as if such drilling operations were upon or such production was from the land described in this lease whether the well or wells be located on the land covered by this lease or not. The entire acreage pooled into a unit shall be treated for all purposes, except the payment of royalties on production from the pooled unit, as if it were included in this lease. In lieu of the royalties herein provided, lessor shall

leased lands with other lands so as to create production units for gas of 640 acres, plus a tolerance of 10% thereof, and the lessor is entitled to payment only of his proportionate part of the royalty accruing from the unit production. In addition, after the lessee has filed a written unit designation in accordance with the lease, the entire area is treated for operational purposes as one lease, and drilling operations and production on any part of the unit area is deemed to be operations or production on the land described in each of the oil and gas leases pooled and included in the unit. Thus it is possible for a lessee to pool only a part of the land covered by his lease in a production unit and thereby hold the entire lease. However, if this situation continues indefinitely, the lessor should be entitled to enforce the covenant implied in an oil and gas lease to reasonably develop the leased premises.[30] In passing, there may be overriding royalty and production payment interests in the lease production and while it is recognized that such interests are automatically subject to being pooled with the royalty by the lessee, it is better practice to make specific provisions therefor in the instrument creating such interests. Other problems of pooling and unitization are outside the scope of this subject.[31]

There is another problem arising out of the relationship between the lessors and the lessees with respect to the sale of gas which I have not hereinbefore mentioned, and that is the nature and extent of the obligation of the lessee to market gas. While this obligation is perhaps subject to being otherwise determined, the courts and text writers of this country have considered this problem primarily under the rules and decisions dealing with implied covenants. Professor Merrill, in defining the four implied obligations of the lessee under the ordinary oil and gas lease, lists as his third implied covenant:

> "III. The implied covenant for diligent and proper operation of the wells and for marketing the product, if oil or gas is discovered in paying quantities."[32]

Although the implied covenant of the lessee to market production

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receive on production from a unit so pooled only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit or his royalty interest therein on an acreage basis bears to the total acreage so pooled in the particular unit involved.

30. See, generally Merrill, *op. cit. supra* note 25, c. III.

31. For a good discussion of some of the problems arising from pooling and utilization, see Walker, *Developments In The Law Of Oil And Gas In Texas During The War Years*, 25 Tex. Law Rev. 1 (1946), and Jones, *Non-Participating Royalty*, 26 Tex. Law Rev. 569 (1948).

32. Merrill, *op. cit. supra* note 25, §4.

under an oil and gas lease is well established,[33] there has been no exact definition of the duties and obligations imposed on the lessee thereunder. Rather, it has been stated somewhat ambiguously that the lessee has the duty to market oil and gas as and when a reasonably prudent and diligent operator would do so under the same similar circumstances.[34] Thus, the duty to market is not an absolute one, and the lessee is not required to produce and market at a loss,[35] but is required to do whatever is reasonable under the circumstances.[36]

A consideration of this marketing obligation necessarily involves not only the question of the lessee's obligation to market production but also whether the lessee is under a duty to prepare or treat the gas to make it marketable, to transport it, to construct facilities for utilization and marketing, and to account therefor. As we consider these ancillary matters, it is important to keep in mind the well recognized rule that the lessee's marketing obligation is measured at the well head, and in the absence of lease provisions to the contrary, the payment of royalties on gas production is to be computed on the basis of the market value at the well.[37]

The duty of a lessee under this implied marketing covenant is to be diligent in securing a market for the lease production, and if this is done, the lessee has complied with this covenant. However, several of the text writers have theoretically suggested that the lessee is obligated, at his own expense, to do whatever may be

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33. Kretni Development Co. v. Consolidated Oil Corp., 74 F.2d 497 (10th Cir. 1934); Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943); Mills and Willingham, Law of Oil and Gas §130 (1926); 2 Summers, Oil and Gas §400 (1938); Walker, *The Nature of the Property Interests Created By an Oil and Gas Lease in Texas*, 11 Tex. Law Rev. 437 (1933), and many other authorities.

34. Newell v. Phillips Petroleum Co., 144 F.2d 338 (10th Cir. 1944); Armstrong v. Skelly Oil Co., 55 F.2d 1066 (5th Cir. 1922); Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943); Rhoads Drilling Co. v. Allred, 70 S.W. 2d 576 (Tex. C.A. 1934); 2 Summers, Oil and Gas §§400, 416 (1938); Siefkin,*supra* note 10, at 183.

35. Merrill, *op. cit. supra* note 25, §90 and Pocket Supplement 38 (1950) and authorities cited.

36. Wilfe v. Texas Co., 83 F.2d 425 (10th Cir. 1936), *cert. denied* 299 U.S. 553 (1936), and other authorities cited herein.

37. Sartor v. Arkansas Natural Gas Corp., 321 U.S. 620 (1944), rehearing denied 322 U.S. 767 (1944); Phillips Petroleum Co. v. Ochsner, 146 F.2d 138 (5th Cir. 1944); Arkansas Natural Gas Co. v. Sartor, 78 F.2d 924 (5th Cir. 1935); Kretni Development Co. v. Consolidated Oil Corp., 74 F.2d 497 (10th Cir. 1934); Clear Creek Oil & Gas Co. v. Bushmiaer, 165 Ark. 303, 264 S.W. 830 (1924); Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943); Scott v. Steinberger, 113 Kan. 67, 213 Pac. 646 (1923); Wall v. United Gas Public Service Co., 178 La. 908, 152 So. 561 (1934); Katscher v. Eason Oil Co., 178 Okl. 634, 63 P.2d 977 (1937); 3 Summers, Oil and Gas §§589, 590 (1938); Mills and Willingham, Law of Oil & Gas §130 (1926); Siefkin, *supra* note 10, at 199; Sneed, *supra* note 1, at 643; Walker, *The Nature of the Property Interests Created By an Oil and Gas Lease in Texas*, 10 Tex. Law Rev. 291, 310-11 (1932); Hardwicke, Problems Arising Out of Royalty Clauses in Oil & Gas Leases 1655.

necessary to render the gas marketable,[38] but the weight of authority appears to support the proposition that, since value of the production at the mouth of the well is determinative, the royalties paid on production should not be computed upon transported or processed values without deducting the lessor's proportionate part of the transportation or processing expense.[39] In fact, even Professor Merrill[40] recognizes that the "transportation to a distant point is no part of the legitimate operating expense of the lease," citing *Voshell v. Indian Territory Ill. Oil Co.*[41] Carrying this thought to its logical conclusion, the point indicated by Professor Merrill, at which he apparently would terminate the lessee's obligation to bear the production and operating expenses of his lessor, can logically be only at the mouth of the well. If this obligation is otherwise construed and the lessee is held liable for the cost of treating and processing the royalty of his lessor, there would result in numerous present day production areas (as where there is a gas-sulphur problem) a situation where the amount paid the lessor as royalty would equal one-fifth or more of the net production proceeds, and the interest of the lessee would be reduced to less than that provided in the lease. This would be contrary to the intention of the lessor and lessee in the execution of the lease. The parties can make a lease providing for one-fifth royalty if they so desire, but the courts should not do it for them by changing through the construction the specific terms of an existing lease.

The construction of facilities for the utilization and marketing of production is a matter which is becoming vitally important in this country. Again, while several of the writers suggest that the marketing obligation should require a lessee to provide this con-

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38. Merrill, *op. cit. supra* note 25, §85; Mills and Willingham, *op. cit. supra* note 26, §129; 3 Summers, Oil and Gas §590 (1938), each writer citing U.S. Tex. Oil Corp. v. Kynerd, 296 Fed. 836 (5th Cir. 1924); Hamilton v. Empire Gas & Fuel Co., 117 Kan. 25, 230 Pac. 91 (1924); Warfield Natural Gas Co. v. Allen, 261 Ky. 840, 88 S.W.2d 989 (1935); Tremont Lumber Co. v. Louisiana Oil Ref. Corp., 187 La. 454, 175 So. 25 (1937); Clark v. Slick Oil Co., 88 Okl. 55, 211 Pac. 496 (1922). But see Siefkin, *supra* note 10 at 192 for an excellent critical analysis of these authorities.

39. Phillips Petroleum Co. v. Johnson, 155 F.2d 185 (5th Cir. 1946), *cert. denied* 329 U.S. 730 (1946); U.S. v. Stanolind Crude Oil Purchasing Co. 113 F.2d 194 (10th Cir. 1940); Armstrong v. Skelly Oil Co., 55 F.2d 1066 (5th Cir. 1922); *In re* Roberts Mining and Milling Co., 35 F. Supp. 678 (D. Nev. 1940); Western Gulf Oil Co. v. Title Ins. & Trust Co., 92 Cal. A.2d 257, 206 P.2d 643 (1949); Vedder Petroleum Corporation v. Lambert Lands Co., 74 Cal. A.2d 720, 169 P.2d 435 (1946); Coyle v. Louisiana Gas & Fuel Co., 175 La. 990, 144 So. 737 (1932); Katscher v. Eason Oil Co., 178 Okla. 634, 63 P.2d 977 (1937); Danciger Oil & Refineries v. Hamill Drilling Co., 141 Tex. 153, 171 S.W.2d 321 (1943); Siefkin, *supra* note 10, at 197, and numerous other authorities. See also Cimarron Utilities Co. v. Safranko, 187 Okla. 86, 101 P.2d 258 (1940).

40. Merrill, *op. cit. supra* note 25, at 219.

41. 137 Kan. 160, 19 P.2d 456 (1933).

struction at his own expense,[42] this proposition is not supported by the authorities. Professor Merrill has recognized this situation, saying:

"The question has been mooted whether the lessee is under an obligation to construct facilities to utilize the production or to furnish an outlet therefor if none exists in the field. An affirmative answer has been suggested by an able writer, provided there is reasonable ground for anticipating profit from the adventure. (Citing Walker, The Nature of the Property Interests Created by an Oil and Gas Lease in Texas, 11 Tex. L. Rev. 399, 438 (1933). Cf. Reynolds v. McMan O. & G. Co., 11 S.W. (2nd) 778, 14 S.W. (2d) 819 (Tex. Com. A. 1929) where the court suggested 'where such question is not voluntarily resolved by the lessee, doubtless it would be solved upon the principles of reasonable diligence in discharging the implied duty of conservation of oil.') The decisions thus far, however, have not enforced any such duty. Thus they have declined to require the lessee to build a pipe line, (Citing Kretni Development Co. v. Consolidated Oil Corp., 74 F. (2d) 497 (C.C.A. 10th, 1934) (cert. den. 295 U. S. 750, 79 L. Ed. 1694, 55 S. Ct. 829 (1935)); Keenan v. Texas Prod. Co., (C.C.A. 10th, 1936) 84 F. (2d) 826) or a refinery (citing Keenan v. Texas Prod. Co. (C.C.A. 10th, 1936) 84 F. (2d) 826) or a plant for the extraction of casinghead gasoline. (citing Armstrong v. Skelly Oil Co. (no. 2) (C.C.A. 5th, 1932) 55 F. (2d) 1066; Crichton v. Standard Oil Co., (La. 1933) 150 S. 668)".[43]

In *Danciger Oil & Refineries v. Hamill Drilling Co.*,[44] wherein the court was considering the provisions of an oil and gas mining contract, Chief Justice Alexander said:

"Hamill contends that since it was provided in the contract that the gas was to be paid for at the 'prevailing market prices paid by the major companies in the Gulf Coast area,' and since the parties knew at the time the contract was made that there was no market in that vicinity for gas such as was being produced from the lease, we should hold, in the light of these 'surrounding circumstances,' that the parties contemplated that Danciger should, at his own expense, manufacture the gas into some product that would be marketable in that vicinity. We are not in accord with this view. It is not infrequent that contracts of this kind are entered into in new fields before a market has been established for the products named. They are entered into in contemplation that a market will be created when the

42. Hardwicke, *Evolution of Casinghead Gas Law*, 8 Tex. Law Rev. 1, 29 (1929) (although Mr. Hardwicke states ". . . It is not believed that such is the law.", Walker, *The Nature of Property Interests Created by an Oil and Gas Lease in Texas*, 11 Tex. Law Rev. 399, 439 (1933); Merrill, *op. cit. supra* note 25, at 221.

43. Merrill, *op. cit. supra* note 25, at 221.

44. 141 Tex. 153, 171 S.W.2d 321 (1943).

supply of goods justifies it. The mere fact that there was then no market in that vicinity for the product then being produced from the lease, is not alone sufficient to justify us in overturning the plain, certain, and unambiguous terms of the contract. In order for us to sustain Hamill's contention it would be necessary for us to write into the contract terms that are not only not embodied therein, but that would be contrary to and in conflict with the terms used therein. Hamill's contention is this respect is overruled."

Other decisions not cited in the foregoing quotation from Merrill, which support the view that normally there is no obligation upon the lessee to construct or erect marketing facilities, are *Freeman v. Magnolia Petroleum Company*[45] and *Risinger v. Arkansas-Louisiana Gas Company*.[46] Due to the required financial investment and the other complicated economic and market factors affecting the enforcement of such an obligation, one writer has suggested that "problem as of today comes perilously close to being academic."[47] In any event, it is submitted that if the lessee in good faith diligently endeavors to secure a market, he has complied with the duty which the lessor and lessee contemplated in the inception of the lease.

Professor Merrill has suggested that as a part of the marketing covenant, "there is an obligation to measure the production accurately and to account with fidelity."[48] Certainly this obligation should exist under any theory of the law and be enforceable without regard to a covenant implied in an oil and gas lease.

An important part of any consideration of this marketing covenant, and the rights of the lessor and lessee with respect to the sale of gas, is the manner of enforcement of such rights and covenant. My time permits me only to indicate here certain suggested procedures. Ordinarily, the remedy for the breach of the marketing covenant is by an action on the lease contract to recover damages,[49] and the measure of such damages may be the lost royalty which would have been realized if the lessee had complied with the covenant.[50] However, the failure to comply with

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45. 165 S.W.2d 111 (Tex. C. A. 1942) (reversed on other grounds, 171 S.W.2d 339 (1943)).

46. 198 La. 101, 3 S.2d 289 (1941); But see Libby v. DeBaca, 51 N.M. 95, 179 P.2d 263 (1947), wherein the lessee was held to be under a duty to erect a plant to manufacture "dry ice" from carbon dioxide gas, there being no purchaser available. *Cf.* Chapman v. Texas Co., 80 F. Supp. 15 (E. D. Ill. 1948); Kirke v. Texas Co., 186 F.2d 643 (7th Cir. 1951).

47. Siefkin, *supra* note 10, at 209.

48. Merrill, *op. cit. supra* note 25, at 222.

49. Merrill, *op. cit. supra* note 25, §148. See also Walker, *supra* note 42; Siefkin, *supra* note 10, at 181.

50. Merrill, *op. cit. supra* note 25, §155.

the express or implied terms of the lease may also represent a violation of the tort duty to exercise due care,[51] or as has been stated, the violation of a duty created by contract. Therefore, since it appears that under a given fact situation, the lessor may have an option with respect to whether his action shall sound in tort or contract, it is important to consider the applicable principles of tort and contract law before any such action is instituted.[52]

In conclusion, we have seen a tremendous expansion of the gas industry during the last 15 years, and by reason thereof, many new and complex problems have arisen which have and will hereafter influence the negotiation and preparation of contracts affecting gas production. The lawyer of today not only must draw a contract which will be economically satisfactory to his client but also must consider the effect of Anti Trust and Federal Power Commission regulations and restrictions on the resulting contractual relationship.[53] In this respect, our law is not static but is as fluid as the times. We can only wait and see what tomorrow may bring.

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51. Walker, *supra* note 42, at 441, and numerous other reported authorities. See also Siefkin, *supra* note 10, at 181.

52. Walker, *supra* note 42, at 441. In this articel, Professor Walker points out that by the use of contract remedies, measure of damages, and statutes of limitation, the relation of the parties may be materially affected. See also Brown, *Implied Covenant to Use Due Care*, 19 Tex. Law Rev. 80, 82 (1940).

53. A recent Federal decision involving Federal Power Commission jurisdiction could have a lasting effect on the gas industry in this country. State of Wisconsin v. Federal Power Commission (Phillips Petroleum Co., Intervenor), 205 F.2d 706 (D.C. Cir. 1953).