The Lessor's Royalty and Take-or-Pay Payments and Settlements Under Gas Sales Contracts in Louisiana

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INTRODUCTION

Contracts for the sale of natural gas customarily include a take-or-pay clause, which has been defined as "requiring the purchaser to take, or failing to take, to pay for the minimum annual contract volume of gas which the producer-seller has available for delivery. Under such a clause the purchaser usually has the right to take the gas paid for (but undelivered) in succeeding years. Such gas is called makeup gas." The natural gas market of the 1980's, due to the declining demand for gas, has seen pipeline purchasers forced to make either of two types of payments to their producers when they are unable to take the minimum bill specified in the gas sales contract. The first of these payments is known as a take-or-pay payment, which generally corresponds with the total cost for the minimum volume of gas required to be taken. The second type of payment is known as a take-or-pay settlement, which, although not contemplated in the contract, is made by the pipeline to the producer in exchange for the relinquishment of the take-or-pay obligations with which the pipeline is unable to comply. This latter payment is generally advantageous both to the pipeline and the producer, enabling the pipeline to avoid the inevitable financial constraints imposed by the take-or-pay obligation, and ensuring the producer an uninterrupted market for his gas.  

This article will address the issue of whether Louisiana lessors are entitled to royalty on take-or-pay payments or settlements received by their lessees from purchasers under gas sales contracts.

HISTORY AND BACKGROUND OF TAKE-OR-PAY CLAUSES

Of vital importance in a gas sales contract is the provision which specifies the quantity of gas to be purchased. That both lessors and their lessee-producers have a valid interest in minimum take provisions can be established by a brief review of the market history of natural gas. Monopsony conditions prevailed in the natural gas industry from...
the 1930's to the 1950's, during which period producers were obligated under gas contracts to sell gas for indefinite or long terms at fixed prices. At the same time, pipelines had the prerogative to forego purchases under conditions of diminished demand, since early contracts contained no minimum take provisions. As a result, pipelines were able to, and in fact did, shut in wells when the demand for gas was depressed, leaving lessors and their lessee-producers with little or no revenue.

While price was, and remains, an important concern in negotiating gas sales contracts, it has never been the prime consideration for two reasons. First, total revenue is simply a function of quantity and price. While a producer may, in theory, negotiate a high price for his gas, he will receive no benefit if no gas is in fact sold. The effect of quantity thus tempts the importance of price in the total equation. Second, the price of natural gas sold for resale in interstate commerce has been regulated for several decades at prices below those which would otherwise be established by the market. The ceilings established by price regulations thus further limited the importance of price as a factor in the negotiation of gas sales contracts.

When market conditions changed, and the demand for gas increased, producers wanted to establish some mechanism whereby purchasers would be contractually obligated to purchase a minimum quantity of gas. After the interstate pipeline systems were constructed, producers achieved their goal by including minimum take provisions which required that “a quantity of gas be taken on a daily basis (the daily contract quantity or DCQ) proportionate to the total amount of recoverable reserves covered by the contract.” These provisions further specified that, in the event the minimum quantity was not actually taken, the pipeline would nevertheless have to pay the equivalent value of the minimum

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3. Arbaugh, Take or Pay Clauses: Pandora’s Box Reopened?, 5 E. Min. L. Inst. 11-1, 11-5 (1984) [hereinafter Arbaugh]. Monopsony is defined as “a market situation in which there is a single buyer for a given product or service from a large number of sellers.” Webster’s Third New International Dictionary (1969).

4. Arbaugh, supra note 3, at 11-5. See also Johnson, Natural Gas Sales Contracts, 34 Inst. on Oil & Gas L. & Tax’n 83, 109 (1983) [hereinafter Johnson].

5. See Johnson, supra note 4, at 108, discussing gas contracts in the Appalachian region. See also Pierce, Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry, 97 Harv. L. Rev. 345 (1983).

6. See Arbaugh, supra note 3, at 11-5.

7. Id. While the Natural Gas Policy Act of 1978 (NGPA) deregulated to a certain extent the wellhead price of gas, the effects of price regulation are still felt by the industry. The NGPA deregulated over time certain categories of interstate gas and extended regulation over intrastate gas. 15 U.S.C. §§ 3301-3432 (1982) [hereinafter NGPA]. For a thorough review of the effects of the NGPA on take-or-pay clauses, see generally Arbaugh, supra note 3.

bill in the contract. Ultimately, they came to be known as "take-or-pay clauses."

Take-or-pay clauses provide coincidental benefits to both producer-sellers and pipeline-purchasers. The producer realizes two principal benefits from these provisions. First, by requiring the purchaser to take the minimum quantity or pay as if he had taken it, the take-or-pay clause assures the producer a minimum annual income over the term of the gas sales contract. The take-or-pay provision thus "meets the needs of the producer for a steady minimum income to pay his operating costs, taxes, and royalty." Second, the clause may prevent possible drainage to the reservoir by encouraging the pipeline to purchase at a relatively constant level, thus maximizing ultimate recovery and deriving the optimum economic benefit for the lessee-producer and his lessor.

The concomitant benefits to the pipeline are basically twofold. The take-or-pay clause enables the pipeline to meet its objectives relative to its gas supply needs by ensuring a constant supply of gas, while allowing flexibility in terms of the amount of gas it must actually take. Furthermore, take-or-pay clauses generally contain a "make-up" provision, whereby the purchaser may, during a specified period of time following

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9. Id. at 111.
10. Turner, Remedies for Failure to Pay Royalties, 14 Rocky Mtn. Min. L. Inst. 407, 421 (1968) [hereinafter Turner]. See also Milligan, Anatomy of a Gas Purchase Contract, 23 Rocky Mtn. Min. L. Inst. 771 (1977) [hereinafter Milligan]. According to Milligan, "The producer-seller must be concerned with the following factors: a. Production must be great enough to preserve and continue the leaseholds rights. . . . b. Rate of production must be great enough to protect against drainage. c. Depletion of the recoverable reserves must be within a reasonable period of time." Id. at 785. Johnson propounds the same basic theory:

The type of take-or-pay clause will influence the rapidity and the extent of development of the gas reservoirs subject to the contract. A take-or-pay provision which is related to a percentage of well capacity rather than reserves means that the more wells drilled to the reservoir, the more the "take" requirement is increased, and the more rapidly the reservoir is depleted . . . .

Whether gas reservoirs should be depleted rapidly or slowly depends on many factors, some of which are individual to the field. . . . The take-or-pay provision has proved to be one of the most effective tools in dealing with these uncertainties. . . .

Johnson, supra note 4, at 116-17.
11. See Arbaugh, supra note 3, at 11-6:

The value to pipelines of take-or-pay clauses . . . is primarily as a mechanism to provide flexibility in the quantities of gas which may be taken under a sales agreement without encountering a state of contractual default. Although this value is one of doubtful quality under market conditions of excess supply, the value was of great importance when pipelines contracted for gas supplies in market conditions of excess demand. Under those conditions, pipeline companies were ostensibly willing to assume the risk of lowered demand in order to obtain supplies in times when supplies were short.
a take-or-pay payment, receive gas paid for but not taken. Such make-up gas generally comes out of "volumes of gas taken at a later date which are in excess of the minimum amount required to be taken." It is interesting to note, however, that the very economic conditions likely to underlie the necessity of paying for gas rather than taking it will in all probability serve to defeat the pipeline's ability to recoup its gas through the make-up provisions of the contract.

A number of non-economic obstacles may also stand in the way of total recovery of take-or-pay payments by the pipelines. The purchaser's opportunity to recoup may be limited by:

1. Maximum quantity provisions where the pipeline's demand exceeds the maximum quantity allowed.
2. Requirements that the gas be made up within a specified term.
3. Depletion of the reservoir or reduction of production capacity.

The current state of the natural gas market is drastically different from that existing at the time pipelines were compelled to agree to the inclusion of take-or-pay provisions within their gas purchase contracts. As expressed by one author:

Because of an unexpectedly large surge in drilling which followed the passage of the NGPA [Natural Gas Policy Act of 1978] and the decontrol of oil prices, coupled with the transfer of the surplus which had developed in the intrastate market to the interstate market, many pipelines find themselves in a "deliverability surplus," where they are unable to take into their systems all of the gas they have contracted to purchase. . . . At the same time, because of the more rapid depletion rate of the newer fields, these same pipelines are predicting that shortage conditions will return in the period 1985-1990, as the trends in both the supply and demand sides are reversed. Thus, farsighted pipelines are continuing to contract for long-term gas supplies even though their systems are currently full.

It thus appears that issues pertaining to take-or-pay clauses will continue to arise as long as there remains an overabundant supply of, and a diminished demand for, natural gas. The derivative question regarding the liability to royalty of take-or-pay payments or settlements

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12. Milligan, supra note 10, at 786.
13. Note, Oil and Gas: "Take or Pay" Gas Contracts: Are They Subject to Royalty?, 35 Okla. L. Rev. 150, 152 (1982) [hereinafter Note, Oil and Gas].
14. Johnson, supra note 4, at 112.
is now ripe, and litigation has ensued. It is only a matter of time before courts at the appellate level address the issue and provide some certainty in this area of the law which, as of yet, remains clouded.

THE LESSOR'S ROYALTY AND COMMON VARIATIONS OF GAS ROYALTY CLAUSES

Louisiana Mineral Code article 213 defines "royalty" in these terms:

"Royalty," as used in connection with mineral leases, means any interest in production, or its value, from or attributable to land subject to a mineral lease, that is deliverable or payable to the lessor or others entitled to share therein. Such interests in production or its value are "royalty," whether created by the lease or by separate instrument, if they comprise a part of the negotiated agreement resulting in execution of the lease. "Royalty" also includes sums payable to the lessor that are classified by the lease as constructive production.

Neither the terms of article 213 nor the accompanying comments shed any light on whether payments or settlements by gas purchasers to producers under take-or-pay clauses are subject to the lessor's royalty. However, the Mineral Code merely provides a general classification scheme within which contractual provisions may be analyzed. It does not purport to set forth exact definitions which may be applied with clinical precision to every contract coming under the scrutiny of its provisions. Thus the general conventions of contractual interpretation apply to contracts in the realm of mineral law, with the intent of the parties being a prime factor for consideration. Whether the lessor's royalty is due on take-or-pay payments or settlements is therefore ultimately a function of the royalty clause contained in the lease.


17. Nor does the definition contained in article 80 of the correlative concept of mineral royalty directly address the issue. La. R.S. 31:80 (1975) states:

A mineral royalty is the right to participate in production of minerals from land owned by another or land subject to a mineral servitude owned by another. Unless expressly qualified by the parties, a royalty is a right to share in gross production free of mining or drilling and production costs.

18. La. R.S. 31:3 (1975) provides: "Unless expressly or impliedly prohibited from doing so, individuals may renounce or modify what is established in their favor by the provisions of this Code if the renunciation or modification does not affect the rights of others and is not contrary to the public good."
Although there are currently a great variety of oil and gas lease forms in use, there are three basic types of royalty clauses: (1) the proceeds clause, (2) the market value clause, and (3) the market price clause. A typical proceeds clause will provide for royalty in these terms:

On gas . . . saved and marketed by lessee, 1/8th of the proceeds received by lessee at the well, payable monthly. If any such gas is utilized by lessee for a commercial purpose . . . or utilized by lessee for the manufacture of gasoline or other products, the market value at the well of 1/8th of the gas so utilized . . . .

A standard North Louisiana lease provides:

The royalties to be paid by Lessee are . . . on gas . . . 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.

A typical South Louisiana lease provides:

[T]he royalties to be paid by Lessee are: . . . on gas, one-eighth (1/8) of the market value at the mouth of the well of the gas used by Lessee . . . , the royalty on gas sold by Lessee to be one-eighth (1/8) of the amount realized at the well from such sales . . . .

While differences may arguably exist in terms of the deductibility of costs from royalty under the “gross proceeds” and “proceeds” clauses, in general, the three types of royalty clauses are construed identically. Nor can any distinction be drawn among the various clauses from the revenue side of the question. It is thus submitted that the inquiry into whether royalty is payable on take-or-pay payments or settlements is the same regardless of which of these three basic royalty clauses is the focus of the examination.


20. Fischl, supra note 19, at 24 (emphasis added).


23. See Comment, Costs Deductible by the Lessee in Accounting to Royalty Owners for Production of Oil or Gas, 46 La. L. Rev. 895 (1986) [hereinafter, Comment, Costs Deductible].

24. It is of course conceded that where a royalty clause directly addresses the issue,
THE LESSOR'S ROYALTY AND TAKE-OR-PAY PAYMENTS

A cursory analysis of the common varieties of royalty clauses may lead to the inference that, in the absence of an express provision in the lease to the contrary, no royalty is due on take-or-pay payments made by pipelines in lieu of gas purchases. The apparent logic of the argument follows this general line of progression:

1. The Lessor's interest in royalty is founded solely on the terms of the lease, which provides that royalty will equal some specified fraction of gas (1) produced, and (2) saved, sold, or used by the lessee.
2. Gas cannot be sold until it is produced.
3. Gas is not produced until it is reduced to possession at the mouth of the well.25
4. Take-or-pay obligations under gas sales contracts by definition arise only on volumes of gas not produced or sold, and which remain in the ground for production and sale at a later date.
5. The lessor therefore has no royalty interest in payments made pursuant to take-or-pay obligations.
6. Finally, the lessor's royalty interest is preserved because his royalty will be paid when the gas remaining in the ground is eventually produced.

Some courts have yielded to this line of reasoning.26 It is suggested, however, that a closer analysis compels a contrary conclusion, and that to follow such a strict construction of lease royalty provisions is to ignore the economic reality of the take-or-pay payment. It is submitted that the inquiry must go beyond a literal reading of the terms of the lease, and should encompass an analysis of the intent of the parties and the implied obligations of the lessee under Louisiana law. A thorough

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25. It is generally accepted that the production phase of oil and gas operations terminates upon reduction of the minerals to possession at the well. See generally LaGrone, Calculating the Landowner's Royalty, 28 Rocky Min. Min. L. Inst. 803 (1982); 3 E. Kuntz, A Treatise on the Law of Oil and Gas § 42.2 (1967); 3 H. Williams, Oil and Gas Law § 645.2 (1985).

examination in this light reveals critical flaws in the reasoning propounded by those who would strictly construe standard royalty clauses as dispensing with any lessor's interest in the type of payments under consideration here.

The argument that the lessor's royalty is in fact due on proceeds received by the lessee under a take-or-pay clause is premised on the fundamental nature of the lessor-lessee relationship, as reflected by the terms of the lease. It is the royalty provision of the lease which specifies the fractional division between the lessor and his lessee of the product obtained or the value attributable thereto. While lease royalty provisions customarily distinguish between the royalty due on oil and that payable on gas, both provisions reflect the same underlying intent of the parties—a mutual objective in which the lessor provides the land, the lessee provides the capital and expertise, and both share, in some proportion, the product or the value derived therefrom. A review of the lessee's implied obligations under a common royalty provision on oil provides the framework within which his corresponding duties under a gas royalty provision may be analyzed.

A typical North Louisiana lease provides for royalty on oil in these terms:

The royalties to be paid by Lessee are: (a) on oil, . . . one-eighth of that produced and saved from said land, same to be delivered at the wells or to the credit of lessor in the pipe line . . . ; Lessee may from time to time purchase any royalty oil . . . in its possession, paying the market price therefore prevailing . . . 27

A customary South Louisiana lease provides:

[T]he royalties to be paid by Lessee are: (a) on oil . . ., one-eighth (1/8) of that produced and saved from the land. . . . Oil royalties shall be delivered to Lessor free of expense at Lessor's option in tanks furnished by Lessor at the well or to Lessor's credit in any pipe line connected therewith. In the event Lessor does not furnish tanks for such royalty oil and no pipe line is connected with the well, Lessee may sell Lessor's such oil at the best market price obtainable and pay Lessor the price received f.o.b. the leased property . . . 28

Where royalties on gas traditionally represent a share of the value of the product, and that on oil may be payable in kind, the only logical


28. Bath's Form 42 CPM-New South Louisiana Revised Six (6)-Pooling A Rev. 12/79. (See supra note 22 and accompanying text for gas royalty.)
basis for the distinction rests on the different physical properties of the minerals. Professor Harrell describes the reasoning underlying the distinction in these terms:

Oil is fungible; it can be easily stored in tanks and trucked away from the lease or delivered into rail cars. Production is thus not tightly dependent upon selling and it is generally fairly simple to sell the oil to anyone who desires to take it. This greatly influenced the form of royalty provisions in the ordinary lease . . . . Perhaps the most common form reserves to the lessor a fraction of the oil "in kind" with the right to sell, dispose or take as he sees fit. If he fails to do so, the lessee is ordinarily obligated to sell or deliver the lessor's share, for the lessor's credit, to the same pipeline or purchaser as the lessee sells his own oil . . .

On the other hand, gas presents quite different marketing problems. . . . [I]t cannot, as a practical matter, be produced and stored by the lessee. Production is absolutely dependent upon the existence of a pipeline leading from the well to the ultimate consumer. There is also ordinarily no practical method by which a lessor can take his share of the gas or dispose of it independently of the lessee.29

The difference between the royalty provision pertaining to gas and that regarding oil is thus attributable to the different physical characteristics of the products and the attendant marketing implications. There is no basis to support any inference of a different intent on the part of the lessor as to the lessee's obligation to market his share of the gas, as opposed to the correlative obligation in terms of his share of the oil. If oil is produced, and the lessor fails to dispose of his share or take it in kind, the lessee has an obligation to sell the lessor's share under the same terms and conditions as he would sell his own. That the royalty on gas is based on a proportion of the value of the product rather than a share in kind does not support any different treatment of the proceeds received from the sale of that commodity. The essence of the agreement is that both the lessor and the lessee own the product at the well in the relative proportions specified in the lease. This is consistent with the view expressed by the Louisiana Supreme Court in Wall v. United Gas Public Service Co.:30

Previous to the moment the gas reached the surface of the ground, the parties owned nothing so far as the gas was con-

30. 178 La. 908, 152 So. 561 (1934).
cerned, except the right to explore for it and reduce it to possession and ownership. But when the gas reached the surface of the ground, the parties owned it in the proportion of one-eighth to the lessor and seven-eighths to the lessee, and, if it had been contemplated or provided in the lease contract that the gas should be divided in kind, it would hardly be disputed that the division should be made at the well. . . . The reason why the division and delivery is made at the well, in cases where there is to be a division in kind, is that there is where the parties come into ownership of the commodity, there is where title vests. The lessor and lessee are vested with title to the gas at the well. . . . in the same proportion that the oil is owned. And while there is to be no division of the gas in kind, it is nevertheless contemplated that there shall be a "division," not of the gas in kind but of its value as fixed by the market price. 31

It is therefore submitted that the differences between oil and gas royalty provisions have as their focus the method of payment, and that the parties contemplated no distinction in terms of ownership of the various products, or the obligations of the lessee in terms of marketing production obtained from the leased premises. 32 The lessee's obligations

31. Id. at 178 La. 913, 152 So. 563 (emphasis added).
32. The Louisiana cases dealing with the deductibility of severance taxes from the lessor's royalty bear out this conclusion. The Louisiana Supreme Court stated in Wright v. Imperial Oil & Gas Prods. Co., 177 La. 482, 148 So. 685 (1933):
The effect of this [lease royalty] provision was simply to make the lessee account to the lessors for the gas, going to plaintiffs, at a fixed price in money, instead of in kind. Before plaintiffs could call on defendants to account for the one-eighth gas in money, they had to become, of necessity, at one time, the owners of that quantity of the gas. In the very language of section 7 of the Act of 1922, this provision calls for the payment of the royalty in money rather than in kind— a manner of payment, which it is obvious from the section does not throw the burden of the entire tax, on all gas produced, on the lessee, but makes the lessor pay his part, namely, on the part which went to him or to his benefit.

Id. at 486-87, 148 So. at 686 (emphasis added). The section 7 of the Act of 1922 referred to in Wright deals with the severance tax, and has been codified as La. R.S. 47:636 (1970):

Every person actually engaged in severing oil, gas, or other natural resources from the soil or water . . . under contracts or agreements requiring payment direct to the owners of any royalty interest . . . either in money or in kind, shall deduct from any amount due, or from anything due, the amount of tax herein levied before making such payments.

See also State v. Hope Producing Co., 167 So. 506 (La. App. 2d Cir. 1936); and Comment, Costs Deductible, supra note 23, at 900:
The proportional allocation of the liability for the severance tax on the owners of the oil and gas is responsive to the principal nature of the tax. The severance
should thus be the same for either commodity, and any benefits derived from their sale must of necessity inure to the benefit of the lessor to the extent of his proportionate interest in the product conveyed. This is so, because the lessee, when selling either gas or oil, contracts with the purchaser for the sale of production, which is, in essence, "co-owned" by the lessee and his lessor. That a distinction exists in the terms of the lease as to the method of payment does not support any inference that the fundamental nature of the lease as a cooperative venture is to be modified if gas, rather than oil, is produced. It is on this premise that the following arguments rest and from which they are deduced.

Take-or-Pay Payments Constitute Part of the Sales Price of Gas Delivered

A common take-or-pay clause may be expressed in these terms:

Buyer agrees to take delivery of and to pay for, at the price of $\$(x) per Mcf, or if not taken, to pay for during each contract

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33. While it is perhaps technically incorrect to classify the lessee and his lessor as "co-owners" of the well-head product, that designation inferentially describes the essential nature of the lessor's interest in a specified share of production as royalty. See Wall, 178 La. 900, 152 So. 561.

34. This line of reasoning finds support in the holding of the Kansas Supreme Court in Shutts v. Phillips Petroleum Co., 567 P.2d 1292 (Kan. 1977). The lessee in Shutts sold gas at prices subject to approval by the FPC. The sales proceeds were received under a refund obligation. The lessor's royalty was not paid on the proceeds received until the FPC finally approved the sales price. The lessors then successfully sued for interest on their royalties from the time the sales proceeds were received until the royalties were later paid. Professor Harrell, in analyzing the holding in Shutts, stated:

[T]he conclusion of the court as to the "ownership" of the funds, while perhaps technically incorrect, implicitly reflects the common understanding of the relationship of the lessor and lessee to the fruits of the mining activity. Landowners, lessees, engineers, and even lawyers engaged in the business ordinarily refer to the royalty owner's or lessee's "share" of the production indiscriminately as being the same, whether or not the "1/8 royalty" or "7/8 working interest" arises from a lease providing for an in-kind royalty or from a royalty based on the price received or market value of the product. . . . The court considered it inequitable for the lessee not to share with the lessor the unanticipated profits he was able to derive from use of the money during the time it was held by him under claim of refund. Although technically the lessors did not own or have any claim to the actual proceeds, the court still viewed it as "their" money. This is, in fact, thoroughly consistent with the idea that there is a mutuality of objectives and sharing of benefits in the ordinary mining lease.

Harrell, Developments in Nonregulatory Oil and Gas Law, 30 Inst. on Oil & Gas L. & Tax'n 311, 337-338 (1979) [hereinafter Harrell, Developments (1979)].
year, for the term of this gas purchase contract, a minimum, 
average daily quantity of gas equal to 80 per cent of each well’s 
deliverability.

This clause may be interpreted as providing for the following agree-
ment between producer and pipeline:

The producer agrees to sell all of his gas produced by these 
specified wells to the pipeline, at the price of $(x) per Mcf. The 
pipeline agrees to buy at least 80 per cent of the gas produced 
by those wells. If the pipeline does not take at least 80 per cent 
of the production of those wells, he agrees to pay the producer, 
for the amount of gas actually taken, the equivalent of $(x) per 
Mcf times the volume of gas representing 80 per cent of such 
production.

The economic reality of the agreement is reflected in its ultimate 
impact on the parties. Where the pipeline is unable to take the minimum 
bill and thus pays the difference between the aggregate price per Mcf 
of gas actually taken and the total contract price, the net effect to the 
pipeline is an increase in the price of gas per Mcf.\(^\text{35}\) The concurrent 
effect to the producer is an increase in the price received for the gas 
actually delivered. A reasoned analysis of the intent of both parties 
confirms this deduction.

It is undisputed that “the quantity of a product available for sale 
is frequently highly influential in fixing the price it will bring.”\(^\text{36}\) The 
relevance of quantity in the marketing of natural gas is no exception 
to the general rule. In fact, the maxim may have more relevance in the 
natural gas industry than in virtually any other. With that in mind, the 
argument that the lessor’s royalty is not due on take-or-pay payments 
because there is no production and sale of gas falls. The fact is, assuming 
that the pipeline accepted delivery of one Mcf of gas, there was pro-
duction and such production was sold.\(^\text{37}\) The only issue remaining is

\(\text{35. Assuming the existence of a make-up provision, the excess cost per Mcf may be} \)
\(\text{expressed by the following equation:} \)
\[
\text{Contract price per Mcf X unfilled minimum} \\
\text{Volume of gas actually taken}
\]
\(\text{That the effective price per Mcf cannot be finally determined until the expiration of the} \)
\(\text{make-up term is of no moment. The conclusive effect remains the same: an increase in} \)
\(\text{the cost per Mcf of gas actually taken.} \)
\(\text{36. Harrell, Recent Developments in Nonregulatory Oil and Gas Law, 31 Inst. on} \)
\(\text{Oil & Gas L. & Tax’n 327, 332 (1980) [hereinafter Harrell, Developments (1980)].} \)
\(\text{37. If there was in fact no production, and the pipeline took delivery of no gas, the} \)
\(\text{critical link in the theory is lacking. However, the position that the shut-in royalty provision} \)
\(\text{of the lease satisfactorily addresses the issue merely begs the question. See infra notes} \)
\(\text{46-48 and accompanying text.} \)
the determination of the price received. It is submitted that the price received for the gas actually delivered is the amount paid by the purchaser. The difference between the contract price per Mcf and the total price paid represents the loss of a quantity discount that directly corresponds to the extent to which the contract minimum was not taken.

Mineral Code articles 124 and 125 provide yet another basis from which the argument propounded here may be derived. Article 124 states:

When a mineral lease is being maintained by production of oil or gas, the production must be in paying quantities. It is considered to be in paying quantities when production allocable to the total original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss. 38

Article 125 provides in pertinent part:

In applying Article 124, the amount of the royalties being paid may be considered only insofar as it may show the reasonableness of the lessee's expectation in continuing production. 39

If, in a time of diminished demand, the pipeline-purchaser is taking only a small amount of gas, but is paying under the take-or-pay provision of the contract as if he had taken the minimum bill, the question arises under Article 124 whether there is sufficient production to induce a reasonably prudent operator to continue operations, thus maintaining the lease under the habendum clause. 40 It becomes evident that any argument that take-or-pay payments do not represent part of the purchase price for gas actually delivered has the potential of placing the lessee in the position of facing the loss of his lease. Under articles 124 and 125, it is the production which must be in paying quantities in order to maintain the lease beyond the primary term. Any proceeds received by the lessee that are not attributable to production do not, under article 124, induce the lessee to continue production. If take-or-pay payments are not classified as part of the sales price of gas actually delivered, then they cannot be attributed to the value of production. In that case, they are wholly independent of production, since payments will be made regardless of whether any gas is in fact produced and delivered. The lessee would therefore have an insufficient share in production to induce

40. There being at least some nominal level of production, the well would not be deemed shut-in, and the lease could thus not be maintained by the payment of shut-in royalties. For a further discussion of shut-in royalties, see infra notes 46-48 and accompanyung text.
him to continue operations. Furthermore, under article 125, the resulting meager lessor's royalty would, arguably, be insufficient to show a reasonable expectation on the part of the lessee in continued production.

If, however, the take-or-pay payment were classified as part of the sales price of gas actually delivered, there would be a direct relationship between those payments and production. The lessee's share in production would then be sufficient to induce him to continue operations. Furthermore, as part of the value of production, those payments would be subject to royalty, which would then support an inference of the reasonableness of the lessee's expectation of continued production. It is submitted that to classify the payments in any other manner would be potentially to impose on the lessor and lessee consequences they could neither have contemplated nor intended.

Some theorists approach the issue from the perspective of the maximum lawful price provisions of the NGPA.\(^4\) They argue that take-or-pay payments do not increase the price of gas purchased above the maximum lawful price because the payment is not part of the purchase price. That analysis stops short of recognizing the economic significance of the transaction, however. To say that the payment does not constitute part of the purchase price under the definitions of the NGPA does not mean that it cannot be so regarded for any purpose. An argument based on a strict construction of a definition contained in the NGPA has no relevance when the issue is viewed in light of general economic reality.\(^5\)

41. See Arbaugh, supra note 3, at 11-40, -41.

42. Arbaugh claims that the maximum lawful price argument suffers from two main deficiencies:

First . . . the payment for gas not taken is, at the time made, simply not part of the purchase price. . . . Second, . . . even if take-or-pay payments were regarded as part of the purchase price when made, the argument is premised on the assumption that continued lack of demand will foreclose the purchaser's ability to make up gas paid for but not taken within the period allowed.

Arbaugh, supra note 3, at 11-41. One may infer that Arbaugh's analysis is premised on a strict interpretation of the definition of "contract price" per the NGPA rather than on any generally applicable principles of either law or economics. As noted by the court in Koch Indus., Inc. v. Columbia Gas Transmission Corp., No. 83-990-A (M.D. La. March 14, 1985), aff'd sub nom, In re Columbia Gas Transmission Corp., No. 84-3282 (5th Cir. July 30, 1984), the district court stated that the "maximum law price defense [to the enforcement of a take-or-pay provision] is without merit. It is not supported by the case law and it runs counter to the plain language of the NGPA and regulations promulgated under that statute." Id., slip opinion at 11. The Koch court based its finding on previous holdings in Sid Richardson Carbon & Gasoline v. Internorth, 595 F. Supp. 497 (N.D. Tex. 1984), Southport Exploration, Inc. v. Producer's Gas Co., No. 83-C0-550-BT (N.D. Okla. June 1, 1984), and the language of C.F.R. regulations defining maximum contract price. "Contract price," as defined in the Code of Federal Regulations, means:

(1) The total price paid per MMBtu for delivery of natural gas occurring on
Nor does the interpretation of a statute directed at regulating the affairs of pipelines and producers have any relevance in an analysis of the relationship between a lessor and his lessee. That relationship must be viewed in terms of practical economics rather than with reference to a totally unrelated federal statute. 43

**Take-or-Pay Clauses and the Prudent Operator Standard**

Not only does the inclusion of a take-or-pay provision in a gas sales contract help protect the producer from the economic uncertainties of the natural gas market, it also enables him to fulfill his obligations under the lease. Louisiana Mineral Code article 122 establishes the general standard within which the lessee's actions are to be evaluated:

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*That date . . .

(2) If no deliveries of natural gas occurred under such contract on that date, the total price per MMBtu that would have been paid for delivery of natural gas on that date. . . .

FERC Regulations Under Natural Gas Act, 18 C.F.R. § 271.504(a) (1986) (emphasis added). This language permits the inference that take-or-pay payments should be included under the definitions of "contract price." Nevertheless, the court held otherwise, relying in part on the conclusory statement of the court in *Southport* to the contrary, and the definition of "delivery" per the NGPA as "the physical delivery from the seller."* *Koch,* slip opinion at 10. Finding that a take-or-pay payment is for gas which is *available but not taken,* the court held that the contract price could not be "increased by take-or-pay deficiencies because that price is calculated only with respect to gas which is actually delivered." *Id.* at 11 (emphasis added). The court in *Koch* read the second clause of § 271.504(a) out of existence by its emphasis on the definition of "delivery."

43. Some cases stand for the proposition that take-or-pay payments constitute a part of the sales price. See *Callery Properties, Inc. v. Federal Power Comm'n,* 335 F.2d 1004 (5th Cir. 1964). The *Callery* court stated:

Superior alone contends that for gas not delivered there is no sale, and therefore take-or-pay provisions are beyond the jurisdiction of the Commission under the exclusionary language of § 1(b), 15 U.S.C.A. § 717(b). When viewed realistically in the light of the imperative necessity for long term gas supply commitments, we agree with the Commission that this arrangement constitutes a sale within its power of regulation. 335 F.2d at 1021.

See also *Diamond Shamrock Exploration Co.,* slip opinion at 8, citing Administrative Record Volume 1, document 1, Opinion of the Assistant Solicitor (Jensen Memorandum) at 6 ("Take-or-pay revenues are 'part of the total consideration for the purchase and sale of gas under the contract.'"); Texas Gas Transmission Corp. v. Board of Educ., 502 S.W.2d 82 (Ky. Ct. App. 1973); and R.R. Comm'n of Texas v. Fort Worth, 576 S.W.2d 899 (Tex. Ct. Civ. App.), writ refused n.r.e. The *Diamond Shamrock* court went on to note:

The market value of gas includes some amount that is attributable only to the physical gas itself. The value of gas also includes some amount for all the activities conducted by the gas company in bringing that gas out of the ground and to the market. Royalty is payable on all the normal components of the value, regardless of the ability of the buyer and seller to separate by contract into discrete payments various components of the value of the gas sold. *Diamond Shamrock Exploration Co.,* slip opinion at 10.
A mineral lessee is not under a fiduciary obligation to his lessor, but bound to perform the contract in good faith and to develop and operate the property leased as a reasonably prudent operator for the mutual benefit of himself and his lessor. Parties may stipulate what shall constitute reasonably prudent conduct on the part of the lessee.\textsuperscript{44}

The comments accompanying article 122 state that among the four particular obligations encompassed in the "reasonably prudent operator" standard are the duties "to produce and market minerals discovered and capable of production in paying quantities" and "to protect the leased property against drainage."\textsuperscript{45}

The lessee's duty to market the gas arises from the basic nature of the lessor-lessee relationship. As explained by Professor Harrell:

\textit{[T]he touchstone of all jurisprudence regulating the rights and obligations of parties to a mineral lease has been that where the lessor's return from the contract is to be a fractional royalty based upon production, then, in a very loose and non-technical sense, the arrangement is in the nature of a cooperative venture with the lessor contributing the land and the lessee contributing the capital and expertise necessary to develop the minerals for the mutual benefit of both parties. From this arises 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.}\textsuperscript{46}

An essential element of the general obligation to market the product is the requirement that the lessee "obtain the best price possible for

\textsuperscript{44} La. R.S. 31:122 (1975). Professor Kuntz outlines the standard of performance due by the lessee in terms of his duty to market production in these terms:

The standard of performance uniformly required of the lessee to comply with his implied duty to market oil or gas in the prudent operator standard under which the lessee is required to exercise reasonable diligence or the degree of diligence that would be exercised by an ordinary prudent operator having regard for the interests of both the lessor and lessee.


\textsuperscript{46} Harrell, Developments (1979), supra note 34, at 334.
the gas." In a regulated market where demand exceeds supply, however, the price will automatically be set at the lawful ceiling, leaving no room for bargaining in terms of that element of the contract. It then becomes incumbent upon the lessee to negotiate in terms other than price.

It is submitted that the cooperative nature of the venture together with the derivative obligation to prudently market the gas command that the lessee strike his bargain in terms mutually beneficial to both lessor and lessee. The market conditions in which take-or-pay clauses were negotiated attest to the prudence of lessees who included such provisions in their gas sales contracts. Given the then-existing market conditions and the customary inclusion of take-or-pay clauses, it would have been imprudent to negotiate a contract without them. Thus, one cannot avoid the inverse inference that the negotiation of such a clause represents an affirmative act on the part of the lessee in fulfilling his duty to prudently market. If it is then determined that the contract as a whole establishes a market value of the gas which is consistent with the lessee's obligation to prudently market, any division of proceeds received pursuant to that contract must be allocated to the lessor and lessee according to the fractional division contemplated by the lease. By definition, every element of the gas sales contract, when considered in sum, represents the market value of the gas. To divide the proceeds in any other manner would be contrary to the essential nature of the lease. The lessee is thus hard-pressed to deny his lessor royalty on take-or-pay payments. The crux of the matter is a determination of the value of the gas. Any benefits accruing under a gas sales contract are inevitably based on that value. By very definition the lessee had no value in his lease as to potential purchasers other than that inherent in the gas. It is because of the intrinsic value of the gas itself that the lessee is able to strike his bargain with the pipeline. Any benefits derived from that contract thus have as their source the gas which the lessee is capable of producing. Those benefits of necessity constitute the measure of that product's value.

47. Martin, supra note 45, at 191. See also Merrill, Covenants Implied in Oil and Gas Leases § 84 (2d ed. 1940) ("The concept of diligence in marketing should include the duty to realize the highest price obtainable by the exercise of reasonable effort.").

48. The standard of performance uniformly required of the lessee to comply with his implied duty to market oil or gas is the prudent operator standard under which the lessee is required to exercise reasonable diligence or the degree of diligence that would be exercised by an ordinary prudent operator having regard for the interests of both the lessor and lessee. 5 E. Kuntz Oil & Gas § 60.3, at 125 (1978).

49. Professor Harrell persuasively argues that:

[A]ny determination of the market value of gas which admits the lessee's arrangements to market were prudently arrived at consistent with the lessee's obligation, but which at the same time permits either the lessor or lessee to
The logic of this analysis is most readily apparent when viewed in the context of an abstract, unregulated market. Suppose, for example, the lessee is offered $3.20 per Mcf for his gas without a take-or-pay clause, or $3.00 per Mcf with such a provision. It would seem reasonable to assume that the lessee would be willing to accept less per Mcf with the guaranties of the take-or-pay provision, if he concludes that the expected value under such a contract will equal or exceed the gross receipts anticipated under a contract without the take-or-pay clause. As noted above, the duty to market has been construed to embrace the duty to receive the highest price obtainable for the gas. When the lessor then sues for damages or cancellation of the lease on the ground of the lessee’s failure to prudently market the gas, the lessee has but one defense: “It was more prudent to sell the gas at a lower price with the guaranteed minimum take-or-pay than at the higher price without such a provision.” How, then, can the lessee deny the lessor a fractional share of take-or-pay payments as royalty under the lease? In essence, the contract as confected specifies the value of the gas. That value is either $3.20 per Mcf without a take-or-pay clause, or $3.00 per Mcf with one. The decision to accept one option or the other must be made in terms of the anticipated probabilities of the demand for gas over the life of the contract. On their face, however, each represents a value of the gas theoretically equivalent to the other, and it is on that value that the lessor’s royalty is based. The lessee cannot with any consistency contend that he took the lower price per Mcf with the take-or-pay provision because it was more prudent to do so, and at the same time deny his lessor a share of that value. The duty to market contemplates the mutual benefit of the lessor and lessee.

While somewhat simplistic, the example above serves to illustrate the basic economic reality of the take-or-pay clause in terms of the value of the gas. Those same principles may be applied by analogy to the real-world conditions of the regulated industry in which most gas sales contracts are confected. Let us assume, for example, that the maximum lawful price of gas is $2.80 per Mcf, and that the market demand is such that the market price would be in excess of that amount. The price for gas is therefore effectively fixed at $2.80 per Mcf, and no bargaining is possible as to price. Now, assume that the lessee-producer is in the enviable position of having two pipelines contending for the purchase of his gas in a seller’s market. Pipeline A offers $2.80 per Mcf and agrees to construct at its cost a line from the main pipeline
to the lessee's wells. Pipeline B offers $2.80 per Mcf and promises to take, or pay for it if not taken, at least 80 per cent of production from the lessee's wells, although under this option the lessee will have to construct, at his cost, a line connecting his wells to the pipeline. If the lessee concludes that, given the vagaries of the natural gas market, the expected value of the take-or-pay clause in Pipeline B's offer exceeds the cost of constructing the pipeline, he will contract with Pipeline B.

We can now construct two scenarios under which the lessee will be compelled to raise as a defense the prudence of his contract with Pipeline B. First, assume that the demand for gas remains sufficiently strong to keep production consistently in excess of the minimum bill specified in the take-or-pay clause. Assume further that the lessor is receiving royalty on a regular basis. At the same time, however, his lessee is deducting from those royalties a proportionate share of the cost of constructing and operating the pipeline connecting the wells to the main line. The lessor would thus logically question the reasonableness of the lessee's contract when he could have had the pipeline constructed at no cost and still receive the same price for the gas. The lessor is in effect being deprived of his share of the actual market value of the gas as represented by his proportionate share of the transportation costs currently deducted from his royalty. The lessee's only available defense to an allegation of a breach of his obligation to prudently market will rest on the potential benefits of the take-or-pay clause in the contract with Pipeline B. That argument is without substance, however, if the lessor can derive no benefit from the take-or-pay provision.

The problem is compounded when viewed in the context of a soft market for gas. Assume, given the same terms of the contract suggested above, that the demand for gas diminishes to the point where the pipeline requires less than the minimum bill, and therefore takes a nominal volume of gas but pays as if the minimum quantity were taken. The following results obtain if the take-or-pay payment is not subject to the lessor's royalty. The lessee continues to receive proceeds equivalent to the amount he would have received had the minimum contract quantity been taken. The lessor, however, receives royalty only on the production actually delivered. The lessor's apparent loss is the same as in the example above—the difference in the value of the gas as represented by his proportionate share of the transportation costs currently deducted from his royalty. In effect, however, the lessor may suffer further loss by being short-changed vis-a-vis the lessee in terms of the allocation of transportation cost. Assuming the use by the lessee of the depletion

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50. It is clearly established that, in the absence of express provisions in the lease to the contrary, the lessor must bear his proportionate share of the cost of transporting the gas. See Comment, Costs Deductible, supra note 23, at 902.
method of cost recovery, the lessee who does not receive royalty on take-or-pay payments will bear a greater proportion of transportation costs than would otherwise be allocated to him under the fractional division of proceeds, and costs deductible therefrom, as contemplated in the lease.

This is the inevitable result where cost is allocated on the basis of production obtained, and where the lessee receives payments in excess of that upon which royalty is payable. To the extent the allocation of cost is related to production, any proceeds received by the lessee which are construed as independent of production will be free of costs, thus effectively increasing the cost borne by the lessor when expressed in terms of a percentage of total revenue. Such a result would serve to defeat the allocation of costs and revenues contemplated by the parties and expressed in the lease. The lessee's defense to an action for breach of his obligation to prudently market will rest on the reasonableness of his assumption that the potential benefits of the take-or-pay clause outweighed the cost of constructing and operating the pipeline. No weight may be accorded the defense, however, unless it is concluded that any benefits derived from the provision inure to the mutual benefit of the lessor and the lessee. Such a construction would avoid the problems hypothesized above and would be more clearly in conformity with the intent of the parties and the economic reality of the transaction.

51. Under the depletion method of cost recovery, the total cost to be recovered is allocated proportionally based on the estimated production obtainable from the reservoir. As production is obtained, a fixed cost per designated unit of production is charged, until over time the depletion of the reservoir will result in the total allocation of that particular cost to the entirety of production obtained.

52. The position taken by Louisiana courts in terms of the relationship between the lease agreement and the gas contract lends further support to the argument that royalties are due on take-or-pay payments. The Louisiana cases dealing with the definition of market value in royalty clauses permit the inference that, under Louisiana law, the gas sales contract arises out of the duty to market as implied in the lease agreement, and the two are in fact related. See Henry v. Ballard & Cordell Corp., 418 So. 2d 1334 (La. 1982); Note, Henry v. Ballard & Cordell Corp.: Louisiana Chooses a Point in Time in the Market Value Gas Royalty Controversy, 43 La. L. Rev. 1257 (1983); and Harrell, Recent Developments in the Nonregulatory Law of Oil and Gas, 33 Inst. on Oil & Gas L. & Tax'n 17 (1982). According to Professor Harrell "an oil and gas lease implies a community of interest between the lessor and lessee. . . . [A]ny interpretation which does not reconcile royalty clauses with the lessee's obligation to prudently market the gas will create irreconcilable differences." Harrell, Developments (1980), supra note 36, at 327.

The Texas courts, while recognizing some abstract duty to prudently market the gas, do not recognize any relationship between the lease and the gas sales contract. The Texas Supreme Court stated in Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981), that "our resolution of this problem is based upon the recognition of two separate and distinct transactions, the lease agreement and the gas contract. . . . Exxon's royalty obligations are determined from lease agreements which were executed prior to and wholly independent
Any suggestion by lessees that the inclusion of a shut-in royalty provision in the lease should defeat the application of royalty to take-or-pay payments does not answer, but merely begs, the question. It must be noted that shut-in royalties will not be due as long as any production is obtained. Therefore, it is conceivable that the pipeline would take an inconsiderable amount of gas, while paying as if the minimum contract volume were taken, yet no shut-in royalty would be due because the well would be producing. Furthermore, Professor Kuntz notes that:

A well is not shut-in for want of a market if the lessee has entered into a gas purchase contract dedicating the reserves covered by the lease, and consequently the lessee is not required to make shut-in gas royalty payments under a shut-in gas royalty clause that contains words of covenant and provides for the payment to be made when a well is shut-in for want of a market.\(^\text{53}\)

Finally, the shut-in royalty does not adequately address the problem even if the situation should arise where it would be payable. It is inconceivable that the parties to the lease could have contemplated the possible double payment for the same gas by the purchaser to the lessee, while the lessor merely receives his shut-in royalty. Yet, such could be the result if royalty is not due on take-or-pay payments. Assume, for example, that the demand for gas should become so low that the pipeline would actually take no gas for some period of time, during which the well would be shut-in. The pipeline would therefore pay the producer for the minimum contract volume of gas, though none would in fact be taken. Assume further that the make-up period should pass without the pipeline having been able to recoup any of its gas paid for but not taken. When the lessee later sells the gas, he will, in effect, be paid twice (once by way of the take-or-pay payment and again when it is later sold outside of the make-up period). Yet the lessor would have received only the nominal sums payable under the shut-in royalty provisions of the lease. It would hardly be realistic to conclude that the parties to the lease could have contemplated such a result.

\(^{53}\) 4 E. Kuntz, Law of Oil and Gas § 46.4(C), at 17 (1978). See also Miller v. Nordan-Lawton Oil & Gas Corp., 403 F.2d 946 (5th Cir. 1968) (Gas is treated as being marketed for purposes of the shut-in gas royalty clause when a take-or-pay gas purchase contract is entered into, even though no gas is being delivered under the contract.).
To the contrary, the only logical conclusion is that royalty is due on take-or-pay payments. The logic of such an inference is evident when viewed in light of the theory that the negotiation of a take-or-pay clause helps fulfill the lessee's duty to market. If no shut-in royalty payments are due when a well is shut-in for want of a market (where the lessee has negotiated a take-or-pay provision), the logical inference is that the royalty on take-or-pay payments made pursuant to the gas sales contract supplants the shut-in royalty and in essence constitutes royalty on constructive production. This argument finds further support in the duty generally imposed on the lessee who loses his market to exercise reasonable diligence to secure a new market. That an exception to the general rule exists for lessees obligated under long-term gas contracts, who are relieved of the obligation to pay shut-in royalty when their contracts include take-or-pay provisions, supports the inference that the only logical basis for the exception is the susceptibility of take-or-pay payments to the lessor's royalty.

The lessee's duty to prevent drainage provides yet another incentive for him to negotiate the inclusion of a take-or-pay clause in his gas sales contract. The take-or-pay provision helps the lessee fulfill this duty by providing minimum and maximum takes such that the well will be depleted in a manner consistent with the nature of the reservoir. In this way, a steady stream of production is anticipated which corresponds to the optimum production level so as to assure the most efficient and complete depletion of the reservoir while minimizing the potential loss of hydrocarbons. If the pipeline finds that, due to diminished demand, it will be unable to take the minimum bill, the take-or-pay payment will serve to compensate the lessee and lessor for the loss they otherwise would have sustained, and from which the lessee has the duty to protect his lessor. The take-or-pay payment thus helps prevent, or compensate for:

1. Drainage,
2. Well depletion while waiting for later make-up of gas, and
3. Decrease in the ultimate recoverable amount of gas from the reservoir.

To the extent the lessee can be deemed to have satisfied his duty to protect the leased premises against drainage through his negotiation of

54. Per Kuntz, shut-in royalty payments are not due when the well is shut-in for want of a market, if the lessee has entered into a gas contract with a take-or-pay clause. See 5 E. Kuntz, Law of Oil and Gas at § 60.3, and Miller v. Nordan-Lawton Oil & Gas Corp., 403 F.2d 946 (5th Cir. 1968).

55. "[T]he payment of shut-in royalties does not extinguish the lessee's duty to continue to seek a market for the discovered natural gas." Kramer and Pearson, supra note 45, at 803. See also Townsend v. Creekmore-Rooney Co., 358 P.2d 1103 (Okla. 1960).
a take-or-pay clause, the lessor should share in proceeds derived therefrom in lieu of production. Where the lessee insulates himself from any potential liability to his lessor under one of the implied covenants, any advantage he later derives as a result of such measure must naturally also inure to the benefit of his lessor.

The Expanded Definition of Royalty in the Processed Gas Cases

A major premise underlying the argument that the lessor's royalty is due on take-or-pay payments is that the royalty clause actually encompasses more than a strict reading of its language would dictate. The cases dealing with the payment of royalty on products extracted from the wellhead product provide an analogy from which support for the theory propounded here may be gleaned.

The Louisiana Supreme Court, in *Wemple v. Producers' Oil Co.*, 56 addressed for the first time the issue of whether royalty was due on natural gasoline extracted from gas. The *Wemple* lease conveyed to the lessee "all of the oil and gas in and under" the land, and provided for a royalty of "one-eighth of all oil produced and saved," and "[i]f gas is found . . . $200.00 for the product each year." 57 The lessee completed a number of successful oil wells from which both oil and casinghead gas were produced. The casinghead gas was then processed, resulting in the extraction of natural gasoline. The court held that the lessor was entitled to a royalty of "a one-eighth interest in the casinghead gasoline produced." 58 In so holding, the court noted:

The contract here in question having originally been entered into in 1909, it seems reasonably certain that neither of the contractants considered, or knew of, the possibility of profitably extracting casing-head gas, and it is quite certain that they included no specific provision relating to such gasoline in their contract. 59

The Louisiana courts have consistently recognized the right of lessors to share in value received by their lessees and attributable to a product later extracted from any royalty-burdened minerals, particularly where

56. 145 La. 1031, 83 So. 232 (1919). For a summary of Louisiana jurisprudence dealing with this issue, see Rogers, Royalties on Processed Gas, 14 Inst. on Min. L. 29 (1967) [hereinafter Rogers].
57. 145 La. at 1033, 83 So. at 232.
58. Id. at 1048-49, 83 So. at 238.
59. Id. at 1040-41, 83 So. at 235.
the lessee specifies that royalty is to be based on market value.\(^{60}\) In essence, the construction given by the courts rests upon the theory that the market value of the gas represents the intrinsic value of all its constituent elements. In this sense, the gasoline later extracted from the gas in its raw form must be considered in any determination of the market value of the gas.

Other courts have interpreted market value royalty clauses in a similar manner.\(^{61}\) The lease in *First National Bank v. Pursue Energy Corp.*\(^{62}\) provided for royalty on gas or casinghead gas, either sold off the premises or used in the manufacture of other products, at the rate of one-eighth of the market value, and on sulphur at the rate of one dollar per long ton. The well produced sour gas, which contained a large quantity of hydrogen sulphide. The gas was delivered to a processing plant where the carbon dioxide and hydrogen sulphide were removed. The residue gas was then sold and the hydrogen sulphide gas was further processed into sulphur, which was also sold. The court held that royalty was due on sulphur under the gas clause of the royalty provision rather than under the sulphur clause. Under the court's construction, only gas was "produced"; sulphur was not mined but merely extracted from the gas.\(^{63}\) The court thus viewed the extracted sulphur as a constituent element of the gas. The value of the gas in its raw form at the well was thus in part comprised of that attributable to the product later extracted from it.

The analysis employed by the courts in the processed gas cases can be applied with equal force to the issue under consideration here. That the courts have liberally construed royalty provisions in such a manner as to give effect to the perceived intentions of the parties (where they did not or could not have contemplated the issues later arising) is evident.

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60. See Wall v. United Gas Public Serv. Co., 178 La. 908, 152 So. 561 (1934); Crichton v. Standard Oil Co., 178 La. 57, 150 So. 688 (1933); and Coyle v. Louisiana Gas & Fuel Co., 175 La. 990, 144 So. 737 (1932). However, where the royalty was fixed in the lease at "one-eighth at 3 cents per thousand cubic feet," the court in Gibbs v. Southern Carbon Co., 171 So. 587 (La. App. 2d Cir. 1937), found those decisions inapplicable:

The cases dealing with gas drawn from oil wells and saturated with oil or cases in which the royalty payments were based upon the value of the gas without any definite fixed price, in which instance the gasoline would be considered as giving an added value to the gas in arriving at its true value, have no application to the case at bar.

171 So. at 589. The *Gibbs* court thus found that the lessor had no right to royalty on the gasoline extracted from the gas after it left the well.


62. 799 F.2d 149 (5th Cir. 1986).

63. Id. at 151.
It is equally clear that they have fashioned remedies consistent with the theory that any ambiguities in instruments should be construed against the drafter.64

The application of these general rules of construction to the question at hand renders a result consistent with that arrived at by the courts in the processed gas cases. In the vast majority of cases it is the lessee who either prepares the lease form or submits it to the lessor for his execution. Any ambiguity in the instrument should therefore be construed against the lessee. It is doubtful that either party contemplated the situation of take-or-pay payments being made by pipelines in lieu of accepting delivery of volumes of gas contracted for. The lessor probably never considered the possibility because he is admittedly one step removed from the gas purchase contract. The lessee most likely never considered the take-or-pay clause as anything more than a provision that became standard in the industry as a means of compelling a pipeline to take a specified minimum volume of gas, thus ensuring a relatively steady stream of production. That the time would come when the demand for gas would be so low that it would be paid for rather than taken was in all probability an incomprehensible possibility to producers who had known only extreme gas shortages. It is thus submitted that the issue of royalty on take-or-pay payments was not contemplated by either party to the majority of gas leases in force today.

Furthermore, the courts’ liberal construction of royalty provisions which, if read in their literal sense, would have denied the lessor’s royalty on products extracted from gas in its natural state, lend credence to the theory that royalty is due on take-or-pay payments. The parallel analysis rests on two bases. It is first submitted that the general theory underlying the sulphur cases is founded on the nature of sulphur as a constituent element of the gas as produced in its raw state. The same theory supports the Louisiana decisions pertaining to royalties on processed gas. The sulphur cases can thus be seen as a logical extension of the general current of authority in Louisiana, and should the issue as

64. According to Summers,
The origin of the expression that oil and gas leases are construed in favor of the lessor and against the lessee is to be found in the application of two other well settled rules of construction to oil and gas leases.... [W]here there is uncertainty or ambiguity in a contract the court may look to the nature of the instrument, the nature and characteristics of the business or subject-matter involved and other surrounding circumstances to determine the true intent of the parties.... [W]here there is uncertainty or ambiguity as to the intent or meaning of the writing it will be construed against the party preparing the instrument.... [The construction is usually] favorable to the lessor and against the lessee, for usually it is the lessee who solicits and prepares the lease or furnishes the printed form for execution by the lessor.
Summers, supra note 45, at § 372. See also 1 E. Kuntz, Law of Oil and Gas at § 16.1.
to sulphur arise in this jurisdiction, it is posited that Louisiana courts
would reach a result identical to those obtained in those cases.\textsuperscript{65}
Therefore, since the courts have considered royalty clauses which expressly
provide for royalty on a particular product at a specified rate, and
decided that \textit{that} royalty provision is inapplicable, but that another
clause \textit{is} applicable, which does not directly address the product in
question, but which is more beneficial to the lessor, it is difficult to
support any holding denying royalty on a product not expressly con-
templated in the terms of the lease.\textsuperscript{66} Royalty clauses are thus traditionally
given an expansive reading, producing effects beyond those which would
flow from a literal interpretation.

It is at this juncture that the second leg of the analysis comes into
play. Admittedly, take-or-pay payments are not, in the literal sense,
constituent elements of gas. That a take-or-pay payment lacks the common
\textit{physical} identity with the source from which extracted products
derive their existence does not defeat the analogy, however. The analysis
at its core focuses on the source from which the object of inquiry derives
its value. It is submitted that at the root of both extracted products
and take-or-pay payments will be found the gas at the well-head. The
essential characteristic underlying the decisions in the \textit{First National Bank}
and \textit{Wemple} cases is the \textit{value} of the extracted product attributable to
the gas at the well-head. So it is with the take-or-pay payment. The
source of the value is the same. Without the gas, there would be no
other products to be extracted therefrom. Royalty being due under the
lease on the gas, any value derived therefrom is by definition subject
to royalty. By the same token, without gas, no take-or-pay payments
would be forthcoming. The take-or-pay payment thus has as its basis
the underlying value of the gas. The two are inextricably intertwined,
and in a practical sense, the take-or-pay payment constitutes one element

\textsuperscript{65} When considered in light of the constituent element theory underlying both lines
of cases, any distinctions between the royalty provisions under review become irrelevant.
While a cursory review of the royalty provisions may indicate that the courts deciding
the sulphur cases actually went farther than Louisiana courts would in similar circum-
stances, a more reasoned approach suggests that the results would be the same. The
royalty provision in \textit{First Nat'l Bank v. Pursue Energy Corp.}, 797 F.2d 149 (5th Cir. 1986),
extpressly provided for royalty on sulphur at a fixed amount per ton, yet the court found
royalty to be due under the gas clause because the sulphur was extracted from gas produced.
Similarly, in \textit{Wemple}, 145 La. 1031, 83 So. 232 (1919), the lease expressly provided for
royalty on gas at a fixed amount per year, apparently regardless of the volume actually
produced. The similarities of the royalty clauses in those cases (where they at least arguably
addressed the product on which royalty was the issue), and the theory underlying the
respective courts' findings, further support the inference that Louisiana courts would reach
the same result in a sulphur case arising under the royalty clause at issue in \textit{First National
Bank}.

\textsuperscript{66} See Rogers, supra note 56, and cases cited therein.
of the value of the gas.\textsuperscript{67} It necessarily follows that take-or-pay payments should be subject to the lessor's royalty.

\textbf{THE LESSOR'S ROYALTY AND TAKE-OR-PAY SETTLEMENTS}

The susceptibility of take-or-pay settlements to the lessor's royalty may also logically be considered in terms of the lessee's duty to market the gas. Suppose, for example, the pipeline's demand for gas diminishes to the point where it can no longer take the minimum bill. The purchaser must still pay for the minimum contract quantity under the take-or-pay clause, regardless of the volume of gas actually taken. If, due to financial constraints imposed by the cumulative effects of the market and the take-or-pay payments made to date, the pipeline and the lessee negotiate either a novation of the contract as to the minimum bill requirements, a reduction of the purchase price, or some combination thereof, the lessor will suffer a reduction in his royalty. The logical defense to an action brought by the lessor alleging a lessee's breach of his duty to prudently market the gas would be a denial that it was imprudent to alter the terms of the gas contract. The lessee would invariably respond that a prudent operator would have amended the contract in order to maximize the return available to both him and his lessor. He would thus argue that it would be better to reduce the minimum bill and/or the price of the gas and maintain production, than to force the pipeline to comply with the contract as originally confected and, by posing a threat to his solvency, thereby cut off the market for their gas.

It is the lessee's defense, however, that compels him to admit that the lessor's royalty is due on take-or-pay settlements. It was the lessee who negotiated the take-or-pay provision in the first place, thus committing the pipeline to a minimum volume of gas at a specified price. The lessee then took payments from the pipeline under that provision when the demand for gas was such that the minimum bill could not be taken. Any negotiated price reduction would have been avoidable to the extent the lessee received both take-or-pay payments and settlement proceeds. Those funds would otherwise still be available to purchase gas at the contract price, the proceeds of which would inure to the benefit of the lessor in the form of royalty. The lessee, in effect, helped place the pipeline in the position of threatened insolvency by negotiating the take-or-pay provision, and accepting payments thereunder. When the source of the pipeline's threatened insolvency is its obligation under the take-or-pay clause itself, the lessee cannot simultaneously avoid the

\textsuperscript{67} This analysis eventually leads back to the theory adduced above that the take-or-pay payment actually constitutes part of the sales price of the gas. See supra notes 35-43 and accompanying text.
lessor's royalty and plead the prudent nature of his novation of the gas contract.\textsuperscript{68}

**CONCLUSION**

Take-or-pay provisions were born out of the practical requirements of the gas industry. While a literal reading of the majority of gas leases currently in force would lead to the conclusion that the lessor's royalty is not due on take-or-pay payments or settlements, it is submitted that such a strict construction does not give effect to the intent of the parties. The relevant concern of the parties when drafting provisions in gas leases is not whether gas will actually be produced in the technical sense, but whether they will receive some value attributable to the gas. One element of that value is represented by take-or-pay payments and settlements. The clause under which these payments are made would have no value without the gas, in which the lessor has an interest of some fractional share.

One suspects that the lessee's ability to pay was the basis for the development of royalty clauses conditioning the lessor's interest on the production and sale of gas. Given the market conditions under which the take-or-pay clause arose, it is improbable that either party contemplated actual payment under those provisions of the gas contracts. To say that the terms of the lease reflect the intent of the parties thus begs the question. To the contrary, a conclusion that the lessor's royalty is due on take-or-pay payments and settlements is thoroughly consistent with the theory that "there is a mutuality of objectives and sharing of benefits" contemplated in the gas lease.\textsuperscript{69} The take-or-pay clause in effect creates a situation in which the lessee receives funds which would otherwise be subject to royalty as part of the value of gas removed from the leased premises. To deny the lessor's royalty on proceeds received under those clauses would be to alter the lessor-lessee relationship and abrogate the sharing of benefits contemplated under that contractual arrangement.

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\textsuperscript{68} This reasoning also supports the argument that the lessor's royalty is due on take-or-pay payments.

\textsuperscript{69} Harrell, Developments (1979), supra note 34, at 338.