ORAL ARGUMENT – 04/04/01
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YZAGUIRRE V. KCS RESOURCES

WATT: I represent the royalty owners who are totally dependent on KCS to produce and market their gas. They have watched so far in this case, as shown on Ex. 1 over here, KCS sell the gas for $8, and in that situation the normal expectation of a royalty owner who signed a 1/8 lease would be to get 1/8 of that or $1, less any deductible cost. Instead in this case, KCS has unilaterally declared the spot market price of $2 as the market value...

PHILLIPS: That's not the spot value today is ________________________________ this record?

WATT: That's correct. We're using $8 and $2 as examples of what happened back during this time.

PHILLIPS: But the spot value is quite bit a higher now?

WATT: It is. That's correct. During this case, the price has fluctuated, but the parties are using $8 and $2 to illustrate ______ here. Under that scenario, KCS gets $7.75 and the royalty owner gets .25. That effectively reduces the royalty from 1/8 to 1/32. And KCS escapes paying royalty from $6 worth of gas produced and sold.

ABBOTT: Has there ever been a situation where KCS sold it for less than the spot market?

WATT: Not that I'm aware of.

PHILLIPS: What's the spot market today?

WATT: If you look in the paper, maybe $5. Something like that. It goes up and down. Before I talk about the implied covenant aspects of this case, I want to address the Vela case, because really Vela should not apply to this situation. And if Vela doesn't apply to this situation, then I don't think anybody will dispute that my clients get the $1 like they agreed to when they signed the 1/8th lease.

In Vela, an oil company had dedicated a market value lease to a long term fixed rate contract - 2.3 cents.

PHILLIPS: And that was the best that was available at the time?

WATT: That's right. And in fact in Vela the royalty owners sued also on an implied covenant. And they got a full trial, not a summary judgment like here. And the TC in Vela agreed: the oil company had done well. In 1935 that was all you could get. So they were not in breach of the implied covenant after a finding of fact in the trial.

The oil company once it won the implied covenant claim said, Well I've marketed in good faith. Therefore, the 2.3 cents is market value as a matter of law. That has never been decided before and the royalty owners sued also not only on the implied covenant, which they lost, but on the express market value covenant. In deciding that case, the TC, the CA, and this court all announced the Vela rule. The Vela rule said, We agree. The contract sales price is not necessarily market value. It might be. It might not be. And allowed the royalty owner in Vela to also prove the comparable sales were higher: 13 - 17 cents. So they had a trial on that basis. And in that trial the judge found the market value was 13 cents. The central theme of everything in Vela is predicated on this, is that a royalty owner is not bound by his lessee's sale as to that being market value as a matter of law. In other words the lessee can't say, Hey I sold it for 2 cents, that's market value; you're stuck with it. You can't do that.

In saying that though Vela never says that the royalty owner can't simply look at that marketing effort, say yeah that's a good price, and get paid as a royalty owner.

HANKINSON: If that's the case then, what is the - how do you interpret the language in Vela then that recognizes the plain language in the leases allow for two types of royalty payment provisions: a proceeds provision or market value provision? When you say we don't have to do anything with Vela to go your way in this case, how do you reconcile that aspect of the opinion there are two types of provisions?

WATT: I cover this pretty extensively on page 21 of my brief. But here's what the court was getting at there. Before this court when the oil company says - was protesting: this is horrendously unfair, we've been stuck with that. This court in effect chided the oil company and said, Look you're the one in charge here. You get to do all of the decisions and everything. You knowingly dedicated a market value lease in 1935 to a 40 year, fixed rate contract. In other words, if you didn't want this result to happen, if you didn't want to be found in breach of contract, then you should have attached a proceeds lease to it. That is what the court is talking about in Vela. That has nothing to do with implied covenant law.

HECHT: Isn't it implicit in that a contract entered into a long time ago has little or nothing to do with market value today in any context? Let's say I buy my house two years ago at the height of the market in Austin. Everything goes South. I could possibly argue that my house is worth what I paid for it two years ago. Nobody would buy it at that.

WATT: To understand that let's use the house example. Let's say that we appraise your house today and we use comparable sales. It's worth $100,000. You sell your house for $200,000. And we're trying to determine the value of your house. We would use the $200,000. But let's get beyond that because it's important. You've got to realize that when the parties to oil and gas leases at this time use the phrase "market value", and this is undisputed, what the oil companies were trying to do was to be able to make a sale off the lease and then deduct post production expenses back to get a market value. They always assumed that the sales price would have something to do with the market value.

HECHT: But they're guessing ahead of time what it might do.

WATT: No, they are not really. When we sell the gas they were doing that so they could deduct post-production costs. And that is undisputed in this record. That's the reason they did it. And even today under market value leases, oil companies sell the gas and the proceeds of that are market value. The legislature in 1991 in the division order statutes made that definition. The legislature for a long time, before and after Vela, has defined severance taxes that way. In other words, market value is what a willing buyer gets from a willing seller. The proceeds of that sale are market value.

HECHT: But if say I will sell you gas in 2005 for $5, I'm hoping that the price is going to be close to $5, otherwise I'm either making a windfall or else I'm getting screwed.

WATT: You may be, but I'm just trying to talk about what happened to my client's gas here.

PHILLIPS: You say there's 5 elements to market value.

WATT: If you have to go into a market value determination, there's 5 elements to it. What I"m saying is that Vela never says that a royalty owner can't just look at the transaction that his company has sold the gas for and say that's pretty good, it's a willing buyer, a willing seller, that's market value. However, what the Vela rule says is if the royalty owner objects to that and says that's not the market value, in other words, you have to go to court and have a judicial determination of market value, then there's 3 things that you can use to determine market value. Well what I'm saying is...

PHILLIPS: So you think it rests with the royalty to just say take this or take this ________________? And we find that within Vela?

WATT: Absolutely. There's nothing in Vela that keeps you from doing that.

PHILLIPS: As I understand from some of the amicus briefs, the other states are fairly split on whether they use a Vela approach or proceeds approach in similar type leases.

WATT: But that's all in the Vela situation. This isn't the Vela situation. But you're right.

PHILLIPS: I didn't see any reference to any other state that has this kind of option with the royalty owner ____________________________. I know you object to that ________________.

WATT: No, I don't object to it at all. But you bring up a very good point. You don't see it anywhere because under the Vela situation, the royalty owner has sued the oil company saying what you sold the gas for was inadequate. You didn't get market value. And in that situation some states have applied the Vela rule, some have not.

OWEN: You want it one way for royalty owners. Back when the interstate gas prices were capped and the intrastate market was much higher and companies were getting much less than

market value they still had to pay royalty on market value. Why doesn't it work both ways?

WATT: One, I wanted to display for my client. When my client sells gas. When my client...

OWEN: You want the royalty owner gets a higher price no matter what?

WATT: That's right. And the entire body of implied covenant law has been aimed at preserving it. Making sure the royalty owner gets the best deal.

OWEN: Regardless of the language they used...

WATT: No, no, not at all. I think KCS here sells the gas for $8 and keeps $6. I think that if KCS had put in the lease this language: we're going to base royalty on the spot price of gas. It doesn't matter whether we sell it for more or less, your royalty is going to be paid on the spot price.

OWEN: And that's true. If the contract that the producer was getting was less than spot market, they would still have to pay royalty on the spot market.

WATT: In that example, that's true.

OWEN: So you're saying you get the upside come what may?

WATT: I'm saying that KCS could keep the $6 on ex.1 if they had explicitly got an agreement to it. But by putting the phrase market value in a lease, there is nothing in that that authorizes KCS to sell gas for $8 and keep $6.

ENOCH: As I read the contract market value means market value. You're asking us to say it really means something very technical, something very different in the oil and gas contract. And then you say to avoid the problem where the producer ends up having to pay a higher price no matter what they get for it, well they ought to just put different language in the contract. I'm a little bit confused. We've said since basically days of Vela, we're going to read these by plain language. It's the language they used. We are going to treat them like contracts. And we're not going to kind of go behind them unless there's a reason that we're supposed to go behind them. It seems to me your argument is predicated on our going behind the plain language of this contract and saying it means something different than what the language of the contract means. In response to that problem, you say well they should have used different language that would be say something different.

WATT: No. First off, what I was trying to say in the first instance was Vela doesn't apply to this situation. That's what I'm trying to say in the first instance. If Vela does apply - let's say we apply Vela, we're going to have to go in to a market value determination to get the market value. Then in that instance, then the implied covenants of the lease apply. And this court has clearly held in the Cabbett(?) v. Brown case that there's a duty to get the best current price reasonably available.

PHILLIPS: Doesn't Cabbett(?) talk about the current market price ______________?

WATT: It does. Cabbett was decided in 1987. If Cabbett(?) had wanted to say the duty under a market value lease is to obtain market value using the test that we have enunciated in Vela and Middleton, this court in Cabbett could have said that. It didn't. It said the duty under a market value lease is to obtain the best current price. The best current price is the one that's been paid and is in KCS's pocket currently.

Amoco v. _______ stands for the proposition that if a lessee is in compliance with the express clause -Amoco was a proceeds royalty - the royalty owner sued Amoco saying you should get fair market value for this gas. You're not getting enough. Amoco had been paying royalty strictly based on proceeds. Amoco stands for the proposition that even if you're in compliance with the express clause, you still must comply with the implied covenant. And the language in Amoco there, the pink language is just showing this court's understanding of the difference between an express and implied covenant. Royalties are paid on the base of express covenants. Implied covenants, you don't pay royalties on. You only get monetary damages if you can show breach. In Cavett(?) this court had concerns, it's in the green on ex. 2, that there had been proof of damages and proof of breach. But it said, (in the pink language) the parties can pick either a proceeds clause or a market value clause and their intent will be followed. But it makes clear that that's only if you show a breach in damages. And what we're showing here is that KCS breaches the contract when they keep $6 worth of gas without something that says that can do that. There is no writing that says they can do that.

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RESPONDENT

ROBERTS: In one of his handouts this morning, Mr. Watt makes the point that he has not been cited to any Texas case, and he has not been able to find a Texas case that would set forth the proper rule for determining market price of gas sold under a long-term contract.

It is with a great deal of respect that I would suggest to Mr. Watt, and to this court, that all he has to do is read Vela and not make up a Vela rule, and he will have his answer.

PHILLIPS: Vela and Middleton both talk about you can consider a contract. What does that mean?

ROBERTS: Both Vela and Middleton, if I understood your question, do not say that you consider the contract.

PHILLIPS: I thought that was to be an element _________________.

ROBERTS: No. In neither Vela nor Middleton were the contract prices of the gas under consideration used by the expert witness establishing market value at the _______.

PHILLIPS: I understand that, but I thought that the case indicated they could be.

ROBERTS: They could be.

PHILLIPS: It looks to me like for both of you to read that language as meaning something but all these numbers the low and the high can be thrown to a fact finder and they come up with a number and that's it. It could be radically different from one trial and the next.

ROBERTS: But don't be misled by this. What happened in this case was that the petitioners proffered expert testimony. That expert testimony went only to the GPA (gas purchase agreement) price. The high price. That was the basis of the expert's opinion. His opinion was that that price alone was market value. That is the petitioner's theory here.

HANKINSON: How then does contract price figure in to determining market value?

ROBERTS: In this case our experts did a market value study, and in doing the market value study, the experts as was the case in Middleton and the case in Vela, did not utilize the gas contract price because it was out of line. That's exactly what Exxon was trying to get done in Middleton. It is exactly what Texas Oil and Gas was trying to do in Vela. They wanted their contract price to be the market price.

HANKINSON: But Vela specifically says that this price, referring to the price paid under a gas purchase contract, together with the circumstances of such contract should be considered along with evidence of comparable sales to determine market value. What does that mean?

ROBERTS: That means that if the contract price is a market sensitive price, if the contract has escalators, if it has market outs, if it has escalators that are tied to market, then that contract price may be competent. In this case, the price was, as Mr. Watt has so amply and capably demonstrated, bore no resemblance to market value. Therefore, our experts discarded that. And any other expert, I submit, doing a market value study or analysis would discard it. It's out of line. Just like Exxon's prices in Middleton.

HANKINSON: Why isn't it some evidence though, in fact that's the actual price being paid for the gas. And I understand it's under a long-term contract that was entered into in an earlier point in time. But if it is the actual price being paid for the gas, why isn't that some evidence that fits into the market value of the gas at the time that it's sold, because in fact there's a willing buyer who's paying that amount of money for the gas?

ROBERTS: Your premise is incorrect with great respect. The willing buyer in this case was Tennessee Gas Pipeline. They litigated all the way to this court where they lost. They were not willing. They were anything but willing.

HANKINSON: They might not like the deal that they cut, and so they are not willing in terms of that. But in fact that is the amount of money that's being paid for the gas. So there is - in other words what I'm - I understand that what we're dealing with is the long term contracts and the effect of the market not necessarily being the same at the point in time that we start litigating these royalty issues. But the fact remains though that at a point in time the gas is being sold someone is in fact

paying that price for the gas. And given the language in Vela, my question is why wouldn't that in some way be a factor to be considered in determining market value? Obviously not controlling, otherwise it would be a proceeds clause. But why wouldn't it be a factor?

ROBERTS: It is not a factor because it distorts the market value study and analysis. It is not comparable. It is not even relevant. It is not relevant in that determination. It may be something that is of interest. And of course it is of great interest to the petitioners.

HANKINSON: If we go out into the industry will we find one expert who says it is relevant and another one who says it isn't?

ROBERTS: I don't believe that you would find...

HANKINSON: In other words, when you say it's not relevant aren't we into a battle of the experts in the industry in terms - the argument that exists in the industry between royalty owners and the producers with respect to how relevant that information is?

ROBERTS: No. I'm saying it's not relevant in the gatekeeper sense that the TC, a judge, looks at this matter.

HANKINSON: That's my whole point. If it's relevant with respect to the gatekeeper function, then we're looking at what is going on in the industry and we may have differing opinions about whether or not that's relevant. My question is, why isn't it legally relevant in the sense when we look at what market value is and we look at information about actual purchases and actual sales from that standpoint why wouldn't it be a factor?

ROBERTS: It is not relevant in that sense. I did not say that in the gatekeeper function that it was relevant. As a matter of fact it was legally irrelevant in the gatekeeper function. It is not relevant in the context that you're talking about in this situation because Mr. Watt - actually the trial counsel in this matter - never offered the GPA price into evidence. That is not what the joint rule 166 motion was about. It was the expert's opinion that only the GPA price was market value. Nothing else was market value.

HANKINSON: I understand that that's the record in this case. But I'm interested at this point in time in what the legal rules should be. I understand that you don't agree with that expert because it said that it would have converted then into a proceeds clause because that's the only evidence you want to consider and the trial judge determined that that was not relevant. Let's look beyond what this expert said. Looking at the language in Vela and what I'm concerned about is what should the legal rule be for calculating market value and what kinds of things should be considered in making that determination.

ROBERTS: I believe Justice Baker when he wrote Heritage tells us that. Heritage says that there are two ways to determine market value at the well. The preferred: the first is to use comparable sales. Comparable sales are sales that are comparable in time, quantity, quality and availability of marketing outlets. Not the contract price. The contract price I believe under Heritage

by definition is not to be considered.

I must go back to the joint rule 166 motion. Their expert says only the contract price is market value. He didn't stop there. He said what's more, it's the best comparable sale. That is crazy. It doesn't make any sense. What you're doing in a comparable sale analysis is comparing the price and the gas in question as though it were free and available for sale. That's what this court said. And that's a very key element here it seems to me in Middleton. The gas must be valued as though it is free and available for sale. This gas by the expert of the petitioners was not free and available for sale. This price was available only because it was a dedicated contract - a 20 year contract.

PHILLIPS: Petitioner says that the data from the field is not sufficiently adequate to really establish a market value. For whatever reason that the data we have out there is inadequate for the court to make a fair rule across the state.

ROBERTS: That is not true. It is not an argument that was made at trial. That is not a part of this record. That is argument of counsel at this point in time. And it simply is not true. There are all kinds of publications. There are all kinds of studies that go on all the time. There are a lot. You wouldn't believe it from what the petitioners have told this court, but there are all kinds of people who are following Vela. They are following Middleton. They are following Heritage. They know what the law is. They know what the law has been since 1968.

HECHT: One of the amicus argues that at least the market price vacillates readily. Particularly in current circumstances. So any kind of a long term contract, even if it's not for years and years, would not be a dependable indicator of market value and you would always be in dispute between the royalty owners and the producer as to what should be paid. What's your response?

ROBERTS: You may be in dispute but you shouldn't be, because what the petitioners here are trying to get this court to buy into, is what this court just said in at least very important emphatic landmark black law cases say. Vela and Middleton both say that you determine what the royalty obligation and entitlement is by reference to the lease. What does the lease say? Separate from that is the contract and what the lessee does with the gas once it's produced. The contract doesn't enter into it. That's what this court said in Vela: we are going to make our determination from what the leases say. The leases say market value at the well. The leases don't say proceeds. In Vela you said if you wanted a proceeds royalty, why didn't you make one. This court said the same thing in Piota(?) First Baptist Church of Piota(?) said the same thing.

PHILLIPS: Is this a market where the choice of the type of calculation a royalty owner can have is negotiable? Generally is it just one person making an offer to take gas on your property. And it's take it or leave it as far as the type of royalty ______________?

ROBERTS: You have asked so I am obliged to answer it so I can go outside the record. I represent clients all the time, and we negotiate. I'm doing one right now with Conoco. We negotiate at great length. And what we do because of the fluctuations in market, what you do in both a proceeds and in a market value the well lease, you key your lease to what the market is doing. And

you test as in a proceeds situation, you make sure that the proceeds are not concocted proceeds as they were in Amoco v. First Baptist Church of ______. Those proceeds there were concocted. There Mr. Watt would be correct if he had a proceeds lease here, which he does not, but wants when he said that his clients were dependent upon KCS. His clients are not dependent upon what KCS does with this gas. This is a market value at the well. His clients are dependent upon what the market value at the well does. And as you say Justice Hecht, it does go up and down. It fluctuates widely. And as this court says, it may do that. You said that in Middleton. You said in Middleton, they are different and at times there is great disparity between the two. And that's what we have here.

HECHT: Why doesn't the implied covenant trump part of the value ___________?

ROBERTS: Because the law of this court, the law of Texas is and has been since I believe Waggoner Estate v. Sigler Oil, which is relied upon in Kichi(?). The true rule of Kichi(?) says, this court speaking, the true rule is that the implied covenant arises only out of necessity and in the absence of an express stipulation.

PHILLIPS: If your lease was we will pay you a 1/8 royalty, and that's all it said, then the implied covenant controls; otherwise, it's meaningless?

ROBERTS: Yes. In a market value situation. It would at the beginning of production...

PHILLIPS: Or in a proceeds situation.

ROBERTS: If it says I will pay you a 1/8th royalty, then you would have to - I suppose either it would be an unenforceable oil and gas lease, or you would have to find a basis and necessity. The two keys in Hecci(?) for this sort of thing. Hecci(?) says you have to have necessity...

PHILLIPS: If it is a market value royalty, then it's really irrelevant I think you're arguing what type of contract the lessee makes for the sale of the gas. I mean there cannot be a breach of the implied warranty because at least insofar as the lessor is concerned their oil is never going to be calculated on that, not even from the first day.

ROBERTS: That is correct.

PHILLIPS: So the implied warranty goes away because it's irrelevant.

ROBERTS: It is I believe as Prof. Lowe has told this court in his filing with the court. He uses a very scholarly word. But it is that the implied duty is there. Nascent, I think is what he says. It's there but it never operates. It never develops in a market value lease situation.

I say that Cabbett(?) is dictum. I do say that. I don't think Cabbett(?) controls. I don't think the petitioners think Cabbett controls either. Petitioners here want the highest possible price. As Mr. Watt has pointed out, Cabbett says best current price reasonably available. And I believe it was you Chief Justice who questioned on that point. Doesn't that mean market?

Absolutely it means market. So I don't say that Cabbett is an aberration. I say that Cabett was a market value at the well decision. I say that Cabbett will not give these petitioners what they want.

ABBOTT: But it seems like the best current price reasonably available is the highest you get whether it be the market or what you actually receive.

ROBERTS: If you believe that, then you're going to have to overrule Vela, Middleton, Herritage and all of the cases that Vela, Heritage and Middleton rely upon, and you will do great damage. You will do great damage to the industry because there are a lot of people who have made transactions contrary to what petitioners would have you believe relying upon Vela, Middleton and Heritage. These petitioners would have you believe that nobody follows it. But that's what Judge Brown said in the CA decision in Middleton. Judge Brown said in his general statement in the CA, and it's very relevant to all that you're struggling with here today. Throughout the history of the industry a custom and usage had developed under which the royalty owners were compensated by payment of a designated percentage of the proceeds of the sale of gas. From these proceeds were deducted severance taxes and where applicable the cost of compression or other processing of the gas needed to bring it up to pipeline specifications, and to obtain the liquid content by product. This so called custom and usage largely ignored the exact language of the oil and gas leases and their gas royalty provisions. The complacency of the lease operators were shattered, however, by the holding of the SC of Texas in the case of Texas Oil and Gas Corp. v. Vela. That's what this argument to this court today by petitioners is all about. They want to go back to 1968. Indeed, before 1968. Make it the way it was if it pleases the court because we don't like the idea that we entered into of our own free will and volution to a market value at the well lease in 1973. And my goodness as a result of a 1979 gas purchase agreement our market value at the well does not compare favorably with what the lessee is getting under the contract.

ENOCH: Based on your argument and the cases you cite, and I take it it didn't surprise you that the Dallas court didn't publish this opinion? The court is not supposed to publish an opinion that doesn't break new ground or express new _______ of law and so they didn't publish this opinion.

ROBERTS: Yes, it did not surprise me. This is a reverse Vela. This question has been decided in Vela. This question has been confirmed in Middleton. The way a market value at the well royalty standard is determined is spelled out in Heritage two ways: comparable sales are the best. If you don't have comparable sales in the area, then you use comparable sales at the point of sell, and you deduct reasonable costs therefrom. But in any event it's market value at the well.

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REBUTTAL

WATT: First off, let's be very clear on what happened. And I keep wanting to get this case back to what happened to my clients with KCS. And I agree that the court's decision here may have impact on the industry and we ought to be thinking about that. But first and foremost, in 1973 my clients were handed a standard form bifurcated royalty clause. They did use proceeds. It says these proceeds to be sold at the well at market value ___________________. They were handed

that. It is uncontested and Mr. Roberts was just reading that the industry intent in using those was to deduct post production costs.

PHILLIPS: That forms been around since the 30's.

WATT: Since the 1930's. There was a duty under that to try to get the best price. The same as under Cabbett v. Brown. In 1979, KCS negotiates a gas contract discharging its duty and gets this high price contract. It knows about Vela, so it negotiates paragraph 8(g) in that contract, which assumes that it will be paying royalties based on that high priced contract. And it got indemnity from Tennessee for doing that. In other words, it said to Tennessee, look we're going to use these proceeds to pay market value royalties. We put a market value lease on this contract. We're going to use those proceeds to pay market value. Tennessee, if we get in trouble over that you're going to indemnify us.

Then, not only that, but for 15 years, and this is in the CA's opinion at page 3, and remember there's only well at there for a long time, through the 1980's under the GPA as these prices escalated KCS every month calculated market value based on those prices and paid my clients. It was only when they made a great big discovery in the early 1990's that they embraced Vela and said, wait a minute we're not going to pay royalties that way anymore. That's what...

ENOCH: But they should have paid royalties based on the escalating price of the market price of the gas. I thought you said that during a period of time that the price of the gas was escalating they were paying royalties based on that.

WATT: They were.

ENOCH: And so that's what the contract requires doesn't it?

WATT: The oil and gas lease is what we're talking about. The oil and gas lease provides for royalties on market value.

BAKER: At the well?

WATT: No. The lease says that the royalty will be on the proceeds if the gas is sold at the well, but if it's sold off the lease, then it's market value.

HANKINSON: And what is the legal test for market value? How should it be calculated under your theory?

WATT: Let's do it under Heritage. Heritage is what is obtained between a willing buyer and a willing seller.

HANKINSON: So what's the evidence going to look like, and what can be considered?

WATT: If you will refer to ex. 5. In Vela remember what happened. In the TC the

oil company had won the implied covenant. So they were saying as a matter of law, what we sold the gas for (2.3 cents) that's market value. The trial judge said, well not necessarily. And the CA agreed. And this court agreed with the CA. If you will look on ex. 5, which I have in front of you, the proper rule when gas is sold under a long term contract is to consider 1) the contract price; 2) the circumstances of the contract; and 3) comparable sales. This court said we agree with the CA on how they handled that.

Again, I am telling you that Vela shouldn't apply here, but if it does apply, Vela should apply __________ and we're entitled to a remand.

HANKINSON: But you tried to put on evidence just of the price that was being paid under the GPA. If Vela does apply, how would that fit with what you just cited to us in Vela?

WATT: That's what the oil company did in Vela. The oil company stood by the contract. There was a trial to determine market value. The oil company said, look we're selling gas for 2.3 cents, that's market value...

HANKINSON: I understand, but the court took a different tact(?) on it. And I still am not sure that I understand the answer to the question. I know you say that Vela doesn't apply, but if it does, something should happen. What is the test for market value? How do we determine market value under a market value lease? I just need to know what you want us to say the test is.

WATT: Here's what you do now more than ever. Because gas marketing changes. It will continue to change. Leases were signed in the 1930's, the '40s and the '50s. Use the traditional definition that's in Heritage. Market value is the result of a transaction between a willing buyer and a willing seller. That's it. That will cause more peace...

BAKER: Who's the buyer and who's the seller in your willing?

WATT: The seller is the oil and gas operator, the lessee. The buyer is whoever...

BAKER: A third party.

WATT: Yes.

BAKER: So that's the contract that's not connected with the lease or whatever it's terms are?

WATT: That's correct.

BAKER: Can we apply that same theory to the royalty owner and the lessee what they were willing to pay as a willing buyer and a willing seller under the terms of the lease itself?

WATT: The royalty owner and the lessee don't agree to buy and sell anything under the terms of the lease.

BAKER: But they decide what's going to paid as between them and they negotiate what they think is a reasonable sale between that.

WATT: They should be free to do that. But for a situation which allows somebody to keep $6 of the gas sold, that should be clearly spelled out.

BAKER: What if you use comparable sales, they are available, exactly what gas is being sold at the well over a long period of time and that rises above the price that the lessee is selling to the third party because they are bound. Then under your theory, the lessee has to take that loss?

WATT: Not necessarily. It depends then whether there is an express market value clause or not. If there's a proceeds clause, that's what the court in Vela was telling the producer when it used the language down there in pink. The court in Vela was telling the producer, look if you didn't want to get hung with the result in Vela, you should have used a proceeds clause, then you would not have had any liability in Vela. That was the whole point of what the oil company was trying to say in Vela.

HANKINSON: Is your position then that under the market value royalty clause we should be looking at the contract price because it reflects what a willing buyer and a willing seller will sell the gas for? Is that what you're saying is the market value test?

WATT: Here is my position. If Vela applies, we use the Vela rule, then one side, just like the oil company did in Vela, is free to say a) that the contract price is market value; and the other side can say no it's not, comparable sales. And there's an adjudication and they can have an argument over that.

HANKINSON: Why isn't that a question of law as opposed to a question of fact for the jury? You've now just turned it into a fact question and a battle of the experts. Then each contract is going to be interpreted differently and it's going to depend on whether a jury likes the plaintiff's expert better or the defendant's expert better.

WATT: I know. It's not that good a rule. That's why I'm saying don't apply Vela here.

HANKINSON: That's what I'm trying to understand what you say - I keep hearing from you that market value is the contract price. And that's what should be considered.

WATT: I'm saying yes, that's right.

HANKINSON: Then why doesn't that turn it into a proceeds royalty provision?

WATT: Because it's just a determination of market value.

HANKINSON: So there's really no difference then between a proceeds royalty clause and a market value royalty clause?

WATT: There's a huge difference, but it primarily goes to the deductibility of post production costs.

HANKINSON: So that's the critical factor that the contract price should always be the consideration and then the post production costs are what makes the difference between the clause. That's your view of how we determine market value and distinguish it from proceeds?

WATT: Correct.