IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 94-10039

PHILLIP THOMPSON, et al.,

Plaintiffs-Appellees.

vs.

COLORADO INTERSTATE GAS COMPANY,

Defendant-Appellant,

Appeal from the United States District Court
For the Northern District of Texas

(2:92 CV 0051 J)

(October 5, 1995)

Before Judges REYNALDO G. GARZA, DAVIS, and BARKSDALE, Circuit Judges.

REYNALDO G. GARZA, Circuit Judge:[*]

This case involves a unique factual and contractual dispute over royalty payments, a dispute unlikely ever to repeat itself. In January of 1992 the Royalty Owners sued Colorado Interstate Gas Company (hereafter known as "CIG") for the underpayment of royalties under a Lease dated October 8, 1958 and which originally required a payment of royalties at a rate of "1/8th of the market value" of the gas produced. CIG is not only the producer under the Lease, but is also the owner of the pipeline, the buyer. After a trial by jury, a final judgment was entered against CIG for the principal amount of $915,336.20, plus $242,103.30 in prejudgment interest and $116,027.50 in attorneys' fees.

[*]Local Rule 47.5 provides: "The publicat ion of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that Rule, the Court has determined that this opinion should not be published.

A brief history of the relationship between the Royalty Owners and CIG is helpful in understanding the Lease. In 1975 the Royalty Owners sued CIG seeking damages for alleged underpayment of royalties. They claimed that royalties had been calculated improperly because CIG had failed to include sales of gas in the Texas intrastate market in its determination of market value. The case remained unresolved for several years while the legal issue of whether intrastate sales should be considered in determining the market value of gas dedicated to interstate commerce was being litigated in other cases. Our court ruled against the Royalty Owners' position in Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980), cert. denied, 454 U.S. 1148 (1982), holding:

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

This decision and others that followed capped the royalties in a market value lease at the price allowed by the Federal Energy Regulatory Commission (hereafter known as "FERC") for interstate sales. Once this point was resolved, the Royalty Owners and CIG settled the lawsuit. The Settlement Agreement was signed on December 31, 1981.

In 1978, while the first law suit by the Royalty Owners was pending, Congress passed the Natural Gas Policy Act (hereafter known as "NGPA") of 1978, which created a scheme of maximum lawful prices ("ceiling prices") for the various types of gas sold. The NGPA did not state whether its price scheme was applicable to gas produced by a pipeline company. Accordingly, the Settlement Agreement treated CIG as if it were an "independent large producer" rather than a pipeline company. Thus, in the Settlement Agreement the parties agreed that prior to the deregulation of gas the Royalty Owners would be entitled to royalties based on the independent large producers' NGPA ceiling price for non-rollover contracts.

From the time the Settlement Agreement was reached in 1981 to 1986, there was no dispute between the parties. They had used the published "ceiling prices" of the different gases produced on the lease. In June of 1986, however, the FERC issued Order 451. Order 451 gave parties to gas purchase contracts the right to renegotiate their contracts. It did not have any direct impact on lease agreements. Order 451 did not eliminate the NGPA ceiling rates incorporated in the FERC rate. The ceiling rates continued to be published just as before. Order 451 did, however, establish an "alternative" ceiling rate of 2.85/MMBtu for gas priced under §§ 104 and 106 of the NGPA. The Order gave the producer a one-time right to renegotiate the prices at which gas was sold to the purchaser prior to deregulation.

CIG argues that Order 451 was not in existence when the settlement between the parties was reached in 1981 and therefore is not controlling. To have succumbed to this reasoning would have been the easy way out; unfortunately, when the settlement was reached FERC was regulating the price of § 104 gas. If the parties had not wanted to be subject to any order such as 451 they could have included such a provision in their agreement. Therefore, we must hold that Orders 451 and 451-A do apply.

It is necessary to understand why FERC issued Order 451. For years the government had tried to increase the production of gas in this country and through its regulatory agencies was always attempting to get producers to make more gas available for the market. Section 104 gas was the old flowing gas before the government took the steps to allow higher prices for other types of gas. New gas produced after a certain date received a higher ceiling price than the old § 104 flowing gas. This new gas was called § 103 gas. When an old § 104 gas well declined in production, producers could rework the well to make it flow freely again; gas produced from a reworked well was allowed a higher price under § 107, as § 107 gas. Gas produced from stripper wells, where the reworking was more expensive, were also allowed a higher price; § 108 gas.

The last regulated price for each category of gas was as follows:

For § 104 gas the ceiling price was .577/MMBtu plus tax
For § 103 gas it was 3.446/MMBtu plus tax
For § 107 gas it was 1.38484/MMBtu plus tax and
For § 108 gas it was 5.72/MMBtu plus tax.

FERC was afraid that gas producers would try to sell the high priced §§ 103, 107 and 108 gas, instead of the lower priced § 104 gas. For that reason they passed Order 451, which provided a one-time opportunity to renegotiate gas contracts and obtain up to the new alternative price ceiling for § 104 gas. A thorough reading of Order 451, which was submitted to the jury without explanation, reveals that the maximum ceiling price for § 104 gas of 2.85/MMBtu was not mandated. In June of 1986, when FERC issued Order 451, the order did not eliminate the NGPA ceiling rates incorporated in the FERC rate. The ceiling rates continued to be published just as before. Order 451 did however, establish an "alternative" ceiling rate for gas priced under §§ 104 and 106 of the NGPA. 15 U.S.C.A. §§ 3314 and 3316 (repealed Jan 1, 1993). This alternative ceiling price was in important respects, wholly unlike the ceiling rates that had predated it and that FERC continued to publish.

There were two, and only two, means by which a producer was entitled to the alternative ceiling price. First, the purchaser could voluntarily agree to pay the higher price. Second, the producer could initiate what Order 451 termed a good faith negotiation. A good faith negotiation was an integral part of Order 451 because it ensured that producers did not automatically collect the above-market alternative ceiling price. Order 451-A Fed. Reg. 46,762 at 46,788 (1986). As stated above, the producer was given a one-time right, exercisable at any time prior to deregulation, to initiate a renegotiation of the prices at which gas was sold to the purchaser. As a condition for seeking the alternative ceiling price, producers were required to give the purchaser the right to seek a lower price for any gas in any contract between the parties that contained some §§ 104 or 106 gas. The purchaser and producer could negotiate to raise the price of § 104 gas, usually in exchange for the lowering of the price of the §§ 103, 107 and 108 gas. By raising the price of § 104 gas, which was theoretically below market value, and lowering the price of §§ 103, 107, 108 gases, which were theoretically above market value, the gas would be sold at a price that reflects more closely the market value.

Order 451, and its good faith negotiation process in particular, was intended to ensure that gas was sold at market value. As the FERC later stated in Order 451-A, "In Order 451, the [FERC] adopted a `good faith negotiation rule' primarily in order to assure that old gas is priced at the lower of the new ceiling price of the market price." Order 451-A, 51 Fed. Reg. at 46,784, See Order 451, 51 Fed. Reg. at 22,204 ("By allowing each party to assess the value of the old gas in light of competition and other market forces, [the good faith negotiation rule] should prevent old-gas prices from rising above market values.")

In theory, the good faith negotiation process could produce widely divergent results ranging, for example, from termination of the contract to an agreement to pay a new price up to the alternative ceiling price. See 18 C.F.R. § 270.201 (1993).

The record shows and there is no dispute that only one Order 451 negotiation ever resulted in an agreement to pay the alternative ceiling prices and that this was an isolated instance. Testimony was presented that Williams Pipeline Company, the purchaser, agreed to pay Amoco, the producer, the § 104 alternative ceiling price of 2.85/MMBtu. The contract between the purchaser and the producer had a no-take clause, which allowed the purchaser not to buy any gas from the producer. The purchaser agreed to pay the alternative ceiling price and notified the producer four days later that it did not intend to take any more gas under the contract. In short, the producer got the alternative ceiling price, but did not actually sell anything to the purchaser at that price.

In our case, CIG was both the producer and the purchaser. So, it was agreed that CIG would be treated as a large independent producer for purposes of determining the ceiling price of § 104 gas. The jury was asked whether CIG would have entered into a negotiation with its purchaser by invoking Order 451. The jury was given no guidance by the court. CIG submitted the following proposed jury instructions to the court:

> "In 1986 the federal government through an agency called the Federal Energy Regulatory Commission (FERC) regulated the price at which a producer could sell its gas. The FERC became concerned that the price for the "old flowing gas" (called Section 104 gas) was so low that producers would stop producing the Section 104 gas and would produce a higher cost gas, Section 103 (new gas), Section 107 (enhanced recovery gas), and Section 108 (stripper well gas) instead. The FERC issued an order (called Order 451) which established an optional procedure a producer could follow to raise the price of the producer's Section 104 gas to a market level.
>
> The following rules (steps) apply to the Order 451 procedure:

> First, the Order 451 procedure only applied if the producer voluntarily chose to institute it with its pipeline buyer.
>
> Second, if the producer elected the Order 451 procedure, it was required, if the pipeline buyer requested, to renegotiate the price of higher cost Section 103, Section 107 and Section 108 gas.
>
> Third, the producer could not force the pipeline buyer to pay any price under Order 451. If the producer and pipeline did not agree upon a price for all of the gas, it was released from the contract and the producer would then sell the gas on the open market to another buyer.
>
> A producer faced with Order 451 [sic.] had to [sic.] decide whether or not to invoke Order 451. A producer had to evaluate whether or not it would be better off renegotiating the price for all of its gas, and possibly having to sell the gas elsewhere if an agreement could not be reached, than [the price] it was receiving [under] the existing regulat[ions] [sic.]. The first question you must answer in this case is: Would CIG as an independent large producer of all the gas from the Lease have invoked Order 451 and renegotiated the price for all of the gas?
>
> If you decide that CIG would have invoked Order 451, then you must decide a second question: What price for all of the gas would have been agreed to in an Order 451 renegotiation? Order 451 allowed producers and pipelines to voluntarily renegotiate the price or do so under a "Good Faith Negotiation" procedure. Under the "Good Faith Negotiation" procedure, each side would submit prices that they would be willing to either sell the gas, if a producer, or pay for the gas, if a pipeline company. If Agreement could not be reached, then the producer had the right to sell the gas to another buyer. Therefore, you must determine from all the evidence before you, what price as of July 1989 you believe would have been agreed to had CIG invoked Order 451. You must determine what price was payable as of July 1989 because that would be the "last regulated price" for the gas upon which royalties could be paid to Plaintiffs."

The court below not only refused to give these instructions, but refused to give <u>any</u> guidance to the jury; the jury was left on its own to decipher the provisions of Order 451. The literature on Order 451 and 451-A submitted to the jury was more than 210 pages of complex reading. Without guidance we believe a jury would become lost in this quagmire of regulation. However, an instruction briefly explaining the purpose of Order 451 and outlining the essential framework, similar to the one proposed by CIG would have adequately guided the jury in its deliberations. "It is the inescapable duty of the trial judge to instruct the jurors, fully and correctly, on the applicable law of the case, and to guide, direct, and assist them toward an intelligent understanding of the legal and factual issues involved in their search for the truth." <u>Pierce v. Ramsey</u>

Winch Co., 753 F.2d 416, 424-25 (5th Cir. 1985). Because the jury was not given any more guidance than the text and literature of Order 451 and 451-A, an Order that is not easily understood by laymen or normally incorporated into a contract such as this, we are left with "substantial and ineradicable doubt as to whether the jury has been properly guided on its deliberations" in this rather complex case. Martin v. New Orleans, 678 F.2d 1321, 1325 (5th Cir. 1982), cert. denied, 459 U.S. 1203 (1983). If the jury decides, as it did, that CIG as a large independent producer of gas would invoke Order 451 and enter into negotiations, the next question should have been what price of gas would the producer and buyer have agreed upon. This question should be answered while recognizing two important facets of Order 451: first, the purpose of the renegotiation is to bring the prices of gas to the current market value; and second, not only is the price of § 104 gas subject to renegotiation, but any other gas under any lease between these parties that the producer wishes to bring to the bargaining table is also subject to renegotiation.

The court also erred in its rulings. First, the court held the FERC Order 451 did not apply to the ceiling price for NGPA §§ 103 and 108 gas. Second, the court held § 107 gas qualified as § 104 gas for purposes of obtaining the higher ceiling price of 2.85/MMBtu under FERC Order 451.

Order 451, as initially proposed, provided for the renegotiation of old gas contracts with below-market prices only, and did not permit purchasers to obtain the renegotiation of old gas contracts with above-market prices. Order 451, 51 Fed. Reg. at 22,206. Complaints were lodged that this scheme was unfair. The FERC agreed that, as proposed, the good faith negotiation rule was unbalanced:

> In order to cure these inequities in the operation of the good faith negotiation rule as proposed and to assure that purchasers will have the ability to substantially reduce their cost of purchasing high-cost gas, the [FERC] will modify the good faith negotiation rule as follows. If a producer makes a nomination request with respect to old gas in one contract, the [FERC] will permit the purchaser to seek a lower price for any gas, whether old or new, in any contract between the parties which contains some old gas.

Id. Order 451-A also makes this point:

> The good faith negotiation rule . . . [allows] purchasers, in response to price renegotiation requests of a first seller, to request price renegotiation of any gas sold under the contract placed on the bargaining table by the producer as well as all gas sold under the other contracts with the same first seller which include any old gas.

Order 451-A, 51 Fed. Reg. at 46,763.

Allowing the royalty owners to argue that Order 451 did not involve §§ 103, 107 and 108 gas was completely erroneous. That was one of the main reasons for Order 451-A. When renegotiating under Order 451 all types of gas were on the bargaining table, subject to renegotiation, including §§ 103 and 108 gas.

Once a reworked well has been designated as a § 107 well, it becomes a § 107 well and is not dually qualified as § 104 and § 107. Accordingly, the court could not rule that the § 107 well was a § 104 well entitled it to the § 104 alternative ceiling price of 2.85/MMBtu. This was error.

We must reverse this case for retrial.

This complex case screams for arbitration or settlement, but if it must be retried, we direct the court below to comply with the findings of this court and adequately guide and instruct the jury, using CIG's proposed instructions as a guideline. The lower court may, if it so chooses, explain further the workings of Order 451 so as to apprise the jury of its duty.

One more question remains -- the question of prejudgment interest. The court below awarded the Royalty Owners prejudgment interest at the rate of 10% compounded daily. The court was correct in allowing a rate of interest of 10% because the damages could not be readily ascertained from the contract. Article 5069-1.05 of the Tex. Rev. Civ. Stat., which became effective on September 1, 1987, provides for an annually compounded interest rate. Fortunately, this Court has previously addressed this issue. In Guest v. Phillips Petroleum Co., 981 F.2d 218, 223 (5th Cir. 1993), we found that because the lawsuit was filed after the effective date of the amended article 5069-1.05, the interest should be compounded annually. The Royalty Owners brought suit well after the date of the amendment; accordingly, we find the court below erred in compounding the interest daily. On remand, if the court below grants damages, it may allow prejudgment interest at the rate of 10% but compounded annually instead of daily.

REVERSED.

W. EUGENE DAVIS, Circuit Judge, dissenting:

Because I agree with the district court's interpretation of the parties' settlement agreement, I respectfully dissent.

CIG and the Royalty Owners were embroiled in extensive litigation during the 1970's over how to determine the contract price for gas purchased during the term of the contract (calling for CIG to pay the Royalty Owners 1/6 of the "market value" of the gas CIG used). After years of litigation, they entered into a settlement agreement providing that CIG would pay the Royalty Owners 1/8 of the "FERC Rate" for gas taken from the Royalty Owners' wells. This referred to ceiling rates established by FERC for various categories of gas. This was a reasonably determinate method of pricing until the FERC established a second set of ceiling prices under Order 451. When Order 451 was issued, the parties again disagreed over the contract price for the gas, this time as to which rate set by the FERC was the "FERC Rate" contemplated by the settlement agreement.

The district court, after reflection, decided that the contract terms were unambiguous as a matter of law and rendered judgment accordingly. I agree with the district court that the critical issue here, the price that CIG must pay the Royalty Owners, was controlled as a matter of law by the terms of the parties' settlement agreement. As a result, any deficiency in the jury instructions was harmless error.

The settlement agreement provides that CIG will pay the Royalty Owners 1/8 of the "FERC Rate," defined in the agreement as:

> the FERC's . . . ceiling rate applicable to each well producing Lessor Gas. That is, the wellhead ceiling rate that CIG would be able

> to charge if it were an independent large producer and Lessor Gas were sold in interstate commerce . . ..

The district court read the phrase "able to charge" in conjunction with the term "ceiling rate" as meaning the highest price that a large independent producer is legally allowed to charge under FERC regulations. This is the correct reading of the settlement agreement because "FERC's ceiling rate" refers to a regulatory ceiling rate rather than a market or negotiated price.

The history of the dealings between these parties and the terms of their settlement agreement support the district court's interpretation. The parties were involved in 6 years of litigation over the price term in their contract before they signed this settlement agreement. They knew the trouble that could come from a vague price term and perfected the settlement to avoid such disputes. To make their new price term certain, the parties linked it to the FERC ceiling rate "in lieu of any other rate, reimbursement, or method of measurement." This made the price easily and objectively determinable.

In spite of this history, the majority reads the words "able to charge" as referring to the highest price a willing buyer is willing to pay an independent large producer for its gas. This interpretation of the settlement agreement requires a determination of the market price for the gas in order to arrive at the "FERC Rate." Unfortunately, this places the parties in the same position they were in before the settlement of arguing about "market value." This reading of the settlement requires the parties to continually readjust the price to comport with the price that an independent producer could negotiate in an inefficient and highly regulated market. It also ignores the crucial fact that the purpose of the settlement agreement was to avoid further negotiations (and disputes) over price by pegging the price to the maximum allowable rate under the law.

The majority emphasizes that the new ceiling under Order 451 was an "alternative" ceiling price which required negotiations and Order 451-A required negotiations on all the contracts in existence. These facts are simply not relevant to the interpretation of the settlement agreement. The parties sole objective in referring to ceiling prices was to set a determinate price from which to derive royalty payments.

The "alternative" nature of Order 451's ceiling price is irrelevant because Order 451 clearly allowed a large independent producer to charge $2.85 for § 104 gas under FERC regulations. This is all that mattered under the settlement agreement.

Similarly, Order 451's provision for negotiations is not relevant because these parties had already negotiated their price to be the legal ceiling price for each well under production. They agreed to tie their price to the ceiling price precisely because they did not want to have to renegotiate their contract every time the legal ceiling price or market conditions changed. In the absence of a contract setting the price at the legal ceiling, <u>any</u> price subject to a ceiling is negotiable. The important feature of this case is that the parties have an agreement specifying the ceiling rate as the contract price.

Order 451-A's provision that producers must renegotiate all gas contracts between the same parties is also irrelevant. The settlement agreement specifically states that royalties will be derived from the "ceiling rate applicable to each well." This means that the royalties from any § 104 well will be based on the legal ceiling price for § 104 gas and that royalties from § 103 wells will be based on the ceiling price for § 103 gas etc. The choice of the word "each" rather than "all" or "every" is significant because it requires the parties to determine the price for each well individually.

Finally, the majority is concerned that the new ceiling rate for § 104 gas ($2.85) was above the market price. But in carrying out our task of enforcing the contract, this fact is no more relevant than the fact that the old ceiling price was significantly below the market price for several years.

The district court's interpretation of the Settlement Agreement provides the certainty that the parties intended in settling their price dispute and should be upheld. Orders 451 and 451-A are not relevant except to the extent that they raised the legal ceiling price, or "FERC Rate," for § 104 gas. The fact that § 451's ceiling price was subject to negotiation is not remarkable as all prices subject to a ceiling are negotiable. For these reasons, I would AFFIRM the district court's judgment.