Paying Quantities - How much Production Is Required to Maintain an Oil and Gas Lease In Its Secondary Term?

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"PAYING QUANTITIES - HOW MUCH PRODUCTION IS REQUIRED TO MAINTAIN AN OIL AND GAS LEASE IN ITS SECONDARY TERM"

Introduction

You have heard the expression "all good things must some day come to an end". An oil and gas lease is no exception. The topic of this discussion pertains to cases involving oil or gas wells which have been producing, but at some point during the oil and gas lease's secondary term, the well becomes what is commonly called a marginally producing well.

At this point, a conflict arises between the Lessor and the Lessee. Typically, the scenario goes something like this:

Elmer lives two miles southwest of Dover on the forty that he inherited from his daddy back in 1965. In '65, the old homeplace consisted of a small cabin with an unattached outhouse. Almost two acres had been cleared. Elmer lived happily on the place until '70 when a leasehound working for Carnivorous Gas and Oil, a Texas-based outfit with a branch office in Fort Smith, drove out to the place to see Elmer. After being offered a dollar per acre, Elmer and his wife, Myrtle, signed a lease with Carnivorous for ten years and as long thereafter as oil and gas is produced. Elmer and Myrtle continued to live happily on the place, milking their goats, until late one night in 1980 when
Carnivorous suddenly unloaded a drilling rig in the goat pen and spudded a well.

Elmer now says that his grass won't grow, his well water ain't no good no more, and that his goats quit givin' milk, but we'll save that topic for a later institute.

In about ten days, the ground started rumblin', and one of the geologists told Elmer that the goat pen was sittin' right on top of the mother lode. He also uttered somethin' about high pressure and low volume that Elmer didn't catch.

Before long, Elmer was drivin' a Coup de Ville and had a swimmin' pool filled with Mountain Valley water. From 1980 until 1984, when natural gas prices peaked, Elmer spent most of his time either watchin' the Playboy channel beamed in from space or at the cafe visiting with some of the other boys about the recent FERC orders and administrative rulings. Happy times were here to stay--or so he thought.

Last year, Elmer's royalty checks became smaller and smaller until they wouldn't even cover the payments on his satellite dish. Myrtle refused to tolerate poverty and threatened to leave home. Elmer felt as though his rights had been violated, and his thoughts and anger immediately centered upon the dastardly party that put him in such a situation. That was, his Lessee, Carnivorous Gas and Oil. Furthermore, Elmer's cousin from across the valley told him that another company had just given him $200 per acre to
lease his lands. Elmer quickly calculated that if he could break his lease and cut such a deal, he could cover his payments for another month.

At the same time, Carnivorous also had its problems. The production of its well was quite low but it still wanted to protect the sizable investment it had already made in its lease acquisition and drilling operations. Furthermore, Carnivorous' bright young geologist advised that the mother lode under the goat pen had been depleted and proposed the drilling of another well where the old outbuilding was once located. "The redrill was a sure shot," he said.

Carnivorous' in-house counsel was then consulted about the best ways to perpetuate its lease until new drilling funds could be located to drill the new well.

The conflict is apparent. Elmer wants to break his old lease. Carnivorous wants to hold onto it for speculative purposes.

Upon losing his Cadillac to the local bank, Elmer then hitchhikes into town to see his attorney. Upon his arrival, he announces, "The boys at the cafe tell me that my well is not producing natural gas in paying or commercial quantities and that my lease can be cancelled due to a lack of production. Do something quick!"

In situations such as Elmer's, questions often arise, such as:

QUESTION NO. 1. WHAT PART OF THE LEASE DETERMINES ITS TERM? The habendum clause determines the term of the lease.
The typical habendum clause provides that the lease shall endure for a prescribed term of years, such as five or ten years, and "as long thereafter as oil or gas is produced". The term of years is called the "primary term". The "thereafter" clause is called the secondary term.

Various forms of the "thereafter" clause, which hold the lease in its secondary term can be found including:

(a) "and as long thereafter as oil or gas is produced";

(b) "and as long thereafter as oil or gas is produced in commercial quantities";

(c) "and as long thereafter as oil or gas is produced in paying quantities".

The habendum clause seeks to assure the Lessor that the leased premises will be put in production and that he will be paid a royalty within the primary term of the lease. The Lessee is assured of maintaining his lease so long as adequate production flows from the well.

**QUESTION NO. 2. HOW MUCH "PRODUCTION" IS REQUIRED TO MAINTAIN THE LEASE?**

The objective of the lease is not merely to have oil or gas flow from the ground but to obtain production that is commercially profitable to both parties. Hence, the vast majority of courts have construed the word "produced" in the "thereafter" provisions to mean produced in paying quantities, or to be more accurate, to be produced in
paying quantities to the Lessee. Consequently, when production falls below this amount, the lease automatically terminates.³

The basis of the majority rule is that the parties to the lease intended that a Lessee should not be permitted to hold a lease after the expiration of the primary term for speculative purposes only.⁴

Fundamentally, the question is one of intent of the parties to the lease. The Lessor has given up his own right to explore and develop the premises. The desired return to the Lessor is royalty on production. Courts have concluded that the Lessor was entitled to royalty on the minerals which would be produced by a reasonably prudent operator having in mind the interests of both Lessor and Lessee. Consistent with that conclusion as to the intent of the parties to the lease is the view that the term "production" as used in the "thereafter" provision has reference to paying production or production in paying quantities.⁵

Accordingly, it has been declared that where the term "paying quantities" is used in a habendum clause, the term means paying quantities to the Lessee and that if a well pays a profit over operating expenses, it produces in paying quantities despite the fact it may never repay its costs and that the operation as a whole may prove unprofitable.⁶

Therefore, if revenues from the well exceed operating and marketing expenses, then the well is producing in
paying quantities. However, if operating and marketing expenses exceed revenues, then the well is not producing in "paying quantities", and the lease terminates. It becomes necessary to perform an accounting procedure to compare revenues with expenses. The life or death of the lease could depend upon a cold mathematical calculation.

In the case of Clifton v. Koontz, supra., the Texas Supreme Court announced the prudent operator rule as another method of determining whether a lease is producing in paying quantities. In that case, the court held that in the case of a marginal well, the standard for determining whether the production is in paying quantities within the requirement of the habendum clause was whether, under all of the relevant circumstances, a reasonably prudent operator would continue to operate the well for the purpose of making a profit and not merely for speculative purposes. It was pointed out that the factors properly considered under the prudent operator rule included (a) the depletion of the reservoir; (b) the price obtainable for the product; (c) the relative profitability of other wells in the area; (d) the operating and marketing costs, (e) the net profit derived; (f) the specific lease provisions involved; (g) the reasonable period of time under the circumstances, and finally, (h) whether the lease was being held merely for speculative purposes.

Therefore, in these lease cancellation cases, testimony will probably be introduced showing both the cold
mathematical calculation test and the factors set out in the Prudent Operator Rule.

QUESTION NO. 3. WHAT OPERATING EXPENSES ARE LEGITIMATE DEDUCTIONS FROM REVENUE IN DETERMINING WHETHER THE LEASE IS PRODUCING IN PAYING QUANTITIES?

Operating expenses which are proper deductions from revenue include:

(a) the amount spent for labor expenses needed to operate the well including the pumpers' salaries, switchers' fees, and costs of supervision time;

(b) state production taxes, state property taxes, gross production taxes, ad valorem taxes, state and federal severance taxes, license taxes, school taxes, personal property taxes and mining rights taxes;

(c) possibly the depreciation charge on equipment installed to secure production and possibly depreciation of equipment used to produce oil or gas which could later be salvaged;

(d) administrative or overhead expenses which can be traced to the actual expenses of production;\(^7\) (Skelly Oil Company v. Archer, 163 Tex. 336, 356 S.W. 2d 774)

(e) royalties paid to the Lessor should be treated as operating expenses and deducted from the value of production;

(f) other miscellaneous expenses which have been allowed include costs for electricity, telephone, fuel, repairs, cleaning of the well, use of trucks, transportation and other incidental operating expenses.
Expenses which are not proper deductions include (a) the initial cost of drilling the well; (b) expenses incurred to rework the well; (c) overriding royalties.

QUESTION NO. 4. WHAT TIME PERIOD IS USED TO DETERMINE WHETHER THE PRODUCTION IS IN PAYING QUANTITIES?

One of the most perplexing problems involved in determining whether production is in paying quantities involves fixing the accounting period or the time period over which the Court will determine whether the Lessee has been producing in paying quantities. Obviously, this determination cannot be made on a day-to-day basis, and accordingly, the courts have held that a reasonable period of time must be employed to see if the lease has been producing in paying quantities.8

The Plaintiff's counsel and the Defendant's counsel will both probably introduce evidence covering the time period which they find most beneficial to their respective clients. The court will then determine the reasonable period of time. The time period used by the Court has ranged from a few months to several years.

QUESTION NO. 5. WHAT IS THE EFFECT OF ACCEPTING ROYALTY PAYMENTS OR SIGNING DIVISION ORDERS AFTER PRODUCTION CEASES TO BE IN PAYING QUANTITIES?

Generally, once an event has occurred which calls for termination of the lease, subsequent action or inaction on
the part of the Lessor will not estop him from claiming the lease has terminated.\textsuperscript{9}

It has been held that where a Lessor signed a division order after production had ceased to be in paying quantities, he was not estopped to assert that the lease had terminated.\textsuperscript{10} Similarly, by weight of authority, the Lessor can accept payment of royalties after production ceases to be in paying quantities and can still assert that the lease has terminated. The Lessor is entitled to a royalty on production whether in paying or non-paying quantities, and hence, the acceptance of royalties in no way amounts to a representation that the production was, in fact, in paying quantities. Furthermore, as a practical matter, a contrary rule would be unsound because the Lessor cannot know in many instances whether production is in paying quantities or not.\textsuperscript{11}

QUESTION NO. 6. CAN THE LEASE BE MAINTAINED BY PAYMENT OF SHUT-IN GAS ROYALTIES?

The majority of courts hold that if a lease is not producing or capable of producing in paying quantities, then it may not be maintained by the payment of shut-in royalties. However, where the lease is capable of producing in paying quantities, then the well may be shut in and the lease maintained by the payment of shut-in gas royalties. A lessee who follows this course, however, runs the risk of running amuck of the implied covenant to market his gas in a timely manner. It has been suggested that in
this instance, a prudent lessee who wishes to shut in his lease should obtain a shut-in royalty division order from the lessor. Such a shut-in division order would provide the lessee with adequate protection. Do you think Elmer would sign such a division order, however?

QUESTION NO. 7. IF THE WELL CEASES TO PRODUCE IN PAYING QUANTITIES, WHEN DOES THE LEASE TERMINATE?

As noted before, the modern habendum clause provides in substance that the lease shall remain in force for a term of years such as three, five or ten years and as long thereafter as oil or gas is produced from the land. A vast majority of courts have construed such habendum clauses as conveying an interest subject to a special limitation, rather than as conveying an interest subject to a condition, power of termination or right of re-entry. The consequences of this conceptual classification of the habendum clause as a clause of limitation is that lack of production after the expiration of the primary term results in an automatic termination of the Lessee's interest. The language of the clause clearly supports this construction. While the courts may be generally opposed to a construction that results in an automatic termination, this opposition is not applicable to an oil and gas lease. The special limitation placed on the duration of the Lessee's interest is not a frivolous collateral condition or a whimsical limitation on the use of the interest.
Equitable rules against forfeiture have no application when the thereafter clause is characterized as a special limitation. If equitable factors are introduced to mitigate harsh results, uncertainty is created, and the primary objective of the lease, the production of oil and gas, may be subverted.

QUESTION NO. 8. WHAT ARKANSAS CASE LAW EXISTS?

There was little or no guidance in our reported cases until Turner v. Reynolds Metal Company, 290 Ark. 481, was delivered about two months ago. The facts of that case are as follows: In 1951, the Turners executed an oil and gas lease. It was assigned to Reynolds Metal Company. The habendum clause provided that the lease would remain in effect for a term of ten years and "as long thereafter as oil, gas or any other mineral is produced". In 1957, Reynolds Metal Company drilled the Nichols #1 Well. Reynolds was the operator and held all of the working interest in the well.

The Nichols Well was one of ten wells owned and operated by Reynolds in the Gragg Field in Sebastian County. All production from Reynolds' wells was sold to Arkansas Louisiana Gas Company under a 1963 gas contract. From the date of first sales in 1964 until 1975, the production from the well was quite low. In 1975, Reynolds apparently sensed a problem with their lease and obtained a new agreement from Jean Turner. The agreement stipulated that the lease in question would remain in effect for at
least five more years and then "as long as oil or gas is produced". The agreement further provided that the Nichols well was deemed to be producing gas in sufficient quantities to maintain the lease for the five-year period.

Therefore, at this point, even though the well was a very marginal well, Reynolds Metal had the lease tied up by the new agreement until at least 1980. In October, 1981, Reynolds renegotiated its gas contract at a much higher price.

In November, 1981, Mrs. Turner filed suit against Reynolds seeking to cancel the lease. She alleged that the Nichols #1 unit had ceased to produce natural gas in paying quantities and that her lease had automatically terminated.

After Mrs. Turner filed her suit, Reynolds commenced drilling the Nichols #2 Well at a cost to Reynolds in excess of $250,000. Both Mrs. Turner and Reynolds Metal submitted the case to the Crawford County Chancellor upon a written stipulation of facts in lieu of offering formal testimony. It was stipulated that the Nichols #1 Well generated revenues of $801 in 1980, $585 in 1981 and $333 for the first half of 1982. It was also stipulated that operating expenses for pumper labor totalled $13,200 per year for all ten wells in the Gragg field. If 1/10 of the expense was allocated to the Nichols #1 Well, then its operating expense totalled $1,300 per year. Therefore, the operating expenses from the well appeared to exceed its revenues. No specific stipulation was entered into
pertaining to exact or precise operating and maintenance expenditures arising directly out of the Nichols #1 Well. The stipulation further provided that no production had ever been sold from the Nichols #2 Well.

Upon reviewing these stipulations, the Crawford County Chancellor found that the oil and gas lease did not automatically terminate due to a lack of production and denied Mrs. Turner's request for cancellation of the lease.

This case was duly appealed to the Arkansas Supreme Court under Rule 29. All appeals presenting a question about oil, gas or mineral rights must be heard by the Arkansas Supreme Court and not to the Arkansas Court of Appeals.

On appeal, Mrs. Turner argued that her lease had automatically terminated at the end of the five-year extension due to insufficient production after that time. In support of her position, she argued:

FIRST. Courts in Arkansas will grant cancellation of oil and gas leases. In support of this position, she cited: Mansfield Gas Company v. Alexander, 97 Ark. 167, 133 S.W. 837 (1911); Drummond vs. Alphin, 176 Ark. 1052, 4 S.W. 2d 942 (1928); Ezzell vs. Oil Associates, 180 Ark. 802, 22 S. W. 2d 1015 (1930); Standard Oil Company of Louisiana vs. Giller, 183 Ark. 776, 38 S.W. 2d 766 (1931); Smith vs. Moody, 192 Ark. 704, 94 S.W. 2d 357 (1936); Nolan vs. Thomas, 228 Ark. 572, 309 S.W. 2d 727 (1958); and Byrd vs. Bradham, 280 Ark. 11, 655 S.W. 2d 366 (1983).
SECOND. The habendum clause in her lease allowed the lease to continue so long as gas was "produced". She argued that the word "produced" should mean produced in paying quantities. In support of this argument, she cited: Kuntz Oil and Gas, Section 26.5, McLeon v. Wells, 207 Ark. 303, 180 S.W. 2d 325 (1944), Standard Oil Company of Louisiana vs. Giller, supra; Ezzell vs. Oil Associates, supra, and Ark. Stat. Ann. §53-114(B) (Repl. 1971), our Arkansas conservation act which utilizes the phrase "in paying quantities".

THIRD. That Reynolds failed to maintain production in paying quantities. She pointed to the stipulated facts which showed labor costs to exceed revenues.

Reynolds Metal Company, on the other hand, argued:

FIRST. That Mrs. Turner failed to prove any direct operating costs arose out of the Nichols #1 Well. Reynolds claimed the only proof in the stipulation was the prorated contract pumper cost which covered a total of ten wells. Reynolds argued that the attempt to prorate the cost was too speculative. Reynolds claimed that Mrs. Turner failed to meet the burden of proving the actual expenditures from the well.

SECOND. Reynolds argued that not only had the Nichols #1 Well been producing, but that the Nichols #2 was completed and was now capable of producing natural gas in "paying quantities".
THIRD. Reynolds argued that Mrs. Turner never gave any notice to Reynolds of her intent to declare a forfeiture of the lease. Reynolds claimed this failure indicated Mrs. Turner still recognized that the oil and gas lease was still in effect. Reynolds also argued that any possible forfeiture of the lease was waived by Mrs. Turner since she accepted all of the benefits of her lease until her lawsuit was commenced. In support of this proposition, Reynolds cited Kuntz, Oil and Gas, §26.14(c) and Hodges v. Harrell, 173 Ark. 210, 293 S.W. 25 (1927). Reynolds finally argued that even though an oil and gas lease may not operate profitably, compelling equitable considerations can rescue the lease from termination. Reynolds cited Barby v. Singer, 648 P. 2d. 14 (1982), an Oklahoma Supreme Court decision where the Court held a lease should not be cancelled because a potential increase in the price of gas rescued the lease from termination even though the well was unprofitable at the time.

On December 15, 1986, Justice Darrell Hickman wrote the Arkansas Supreme Court's decision which reversed the Crawford County Chancellor. The Court held:

1. A provision in an habendum clause of an oil and gas lease requiring production means production in paying quantities.

2. Generally, production in paying quantities means production which is profitable to the Lessee.
3. If natural gas was not produced in paying quantities at the end of the five-year extension, the lease may be cancelled.

4. The well was not producing in paying quantities because one-tenth of the contract pumper expenses exceed revenues from the well.

5. The fact that Reynolds drilled a second well and renegotiated his gas price or prices is irrelevant because Mrs. Turner was already entitled to have cancellation of her lease.

In the Reynolds Metal Company case, when the Court held that production in paying quantities means production which is profitable to the Lessee, it set the stage for another case presently pending in the Arkansas Supreme Court.

I filed suit in Crawford County seeking to cancel 22 different oil and gas leases which constituted approximately 30% of the drilling unit. All 22 leases were dedicated under a 17¢ per MCF gas contract. The Well produced marginally for years. Accordingly, revenues obtained under the 22 leases was quite low.

Thirty percent of the proper operating and marketing expenses attributable to the well easily exceeded the revenues coming out of the low-priced gas contracts under which the leases were dedicated.

The other acreage in the unit was dedicated under seven other gas contracts which provided a much higher
price for the sale of gas. The other contracts averaged approximately $1.74 per MCF.

Therefore, the issue became: Do you compare the total revenues derived from the well with the total operating and marketing expenses to determine if the well is still producing in "paying quantities", or can you compare the revenue derived from a single lease with its proportionate share of expense.

The Court in Turner v. Reynolds Metal Company said production in paying quantities means production which is profitable to the Lessee. Therefore, it appears the Court will probably expand its holding in Turner and rule that each lease must stand or fall upon its own revenue compared with its own proportionate share of operating expenses.

Conclusion

After reviewing each of the eight above questions with Elmer, his attorney filed suit on his behalf to cancel his lease. Carnivorous Gas and Oil, stubborn as ever, proceeded to drill their new well near Elmer's old outhouse. Following the reasoning found in Turner v. Reynolds Metal Company, the Court cancelled Elmer's lease, and he suddenly owned a part of Carnivorous' new well. Both Elmer and Myrtle decided that they should get out of the oil business and invest their money in more conservative and reliable endeavors. Elmer then sold all of his interest in the well to Carnivorous for a tidy sum.
which even pleased Myrtle. They were both last seen at the $10 window at Oaklawn.
FOOTNOTES

1. Williams and Meyers, Oil and Gas Law, Section 603.
2. Williams and Meyers, Oil and Gas Law, Section 604.
3. Garcia v. King, 139 Tex. 578, 164 S.W. 2d 509 (1942)
4. Clifton v. Koontz, 160 Tex, 82, 325 S.W. 2d 684
5. Williams and Meyers, Oil and Gas Law, Section 604.5
6. 38 Am Jur 2d., Gas and Oil, Section 214
7. Skelly Oil Company v. Archer, 163 Tex. 336, 356 S.W. 2d 774
8. Williams and Meyers, Oil and Gas Law, Section 604.6c
9. Williams and Meyers, Oil and Gas Law, Section 604.7
10. Gypsy Oil Company v. Marsh, 121 Ok. 135, 248 P. 329
12. Williams and Meyers, Oil and Gas Law, Section 604.
13. Ibid.