

GAPS IN PRODUCTION UNDER HBP LEASES

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INTRODUCTION

Common Lease Maintenance Questions:

- Is our lease still being held by production even if we aren't making a profit?
- What happens if production stops, even if just temporarily?
- Can we shut-in wells because prices are bad?

INTRODUCTION

Roadmap for Today's Presentation:

- *Part One:* What is actually required to hold a lease by production during its secondary term?
- *Part Two:* What are some common types of “savings clauses” that could keep a lease alive during its secondary term when there is no production?

INTRODUCTION

Topics for Another Day:

- Lease maintenance issues during the primary term
- Lease maintenance issues relating to drilling obligations
- Force majeure clauses

INTRODUCTION

Key Things to Remember:

- Every lease is different – look at specific lease language
- Know your facts – amendments, unit agreements, other contractual obligations, etc.

LEGAL BACKGROUND

What does it mean to “maintain” a lease that is in its secondary term?

- Habendum clause = measures duration of the lease by its ultimate objective → production of oil or gas
- Typical language: “*This lease shall be for a term of ___ years and so long thereafter as oil or gas is produced.*”
 - Primary term = fixed number of months/years
 - Secondary term = as long after end of primary term as production continues

LEGAL BACKGROUND

What does it mean to “maintain” a lease that is in its secondary term?

- Habendum clause → *determinable fee interest in the leased land subject to a special limitation*
 - Cessation of production during secondary term automatically terminates the lease
- To “maintain” a lease = prevent it from terminating

PRODUCTION IN PAYING QUANTITIES

What does “production” mean?

- Production of oil or gas is what preserves a lease during its secondary term – *but not just any type of production...*
- “Production” = *production in paying quantities*
 - *“in paying quantities” may not be in the lease*

PRODUCTION IN PAYING QUANTITIES

What does “paying quantities” mean?

- Production of oil or gas that would return a profit, no matter how small, after deduction of certain current costs

~~Drilling, completing, equipping, etc. costs~~

- Thus, “paying quantities” may be met even if lessee takes a net loss

PRODUCTION IN PAYING QUANTITIES

How is “production in paying quantities” determined?

- Test #1: Objective Test (simple calculation of profitability)
- Relevant factors = (1) time frame, (2) revenue stream and (3) deduction of various expenses

PRODUCTION IN PAYING QUANTITIES

Objective Test: *Time Frame Factor*

- TIME FRAME = key factor to consider
- Example – Lease has been producing profit for 15 years but is in midst of six-month span of no profits
 - *Still being held by production? Depends on what time frame is used.*

PRODUCTION IN PAYING QUANTITIES

Objective Test: *Time Frame Factor, cont.*

- Problem: No set period of time exists – can be 6 to 25 months
- “Reasonable” period of time?
- At very least, applicable time frame should not be too short

PRODUCTION IN PAYING QUANTITIES

How is “production in paying quantities” determined?

- Objective Test = simple, but few states use it by itself
- Test #2 – Two-Pronged Analysis:

Objective + Subjective elements

PRODUCTION IN PAYING QUANTITIES

Alternative Test

- First Prong: *Objective test satisfied?*
 - If yes, analysis **stops**.
- Second Prong: *Is lessee acting reasonably in continuing to operate?*
 - If yes, then there is production in paying quantities.

PRODUCTION IN PAYING QUANTITIES

Is production in “paying quantities”?

- Consider all facts and circumstances, not just profits and losses
- Would a prudent lessee, acting in good faith, continue to operate the lease?
 - Must consider lessor’s position
 - Purposely stopping production could be *bad faith*

COMMON SAVINGS CLAUSES

Cessation of Production

- Implied – Doctrine of Temporary Cessation
- Express – Defined in Lease

Shut-In Royalty

- Scope?
- Grounds?
- Common Issues

Other (not covered): Force majeure, drilling clauses

CESSATION OF PRODUCTION

Implied: Doctrine of Temporary Cessation of Production

- Common law doctrine, implied in the lease and based on equitable factors:
 - Cause of cessation
 - Reasonableness of the length of time
 - Lessee's diligence in re-establishing production

CESSATION OF PRODUCTION

Express Cessation of Production Language

“If after discovery of oil, gas or other minerals, the production thereof should cease from any cause, this lease shall not terminate if Lessee commences additional drilling or reworking operations within sixty days thereafter”

CESSATION OF PRODUCTION

Comparison

Express Clause

- ✓ Better for low prices?
- ✗ Earlier termination than implicit?
- ✗ Negates implicit doctrine?

Implied/Common Law

- ↔ Undefined boundaries
- ✓ Longer duration?
- ✗ Risk of rejection by court?

SHUT-IN ROYALTY CLAUSE

The Basic Concept of Shut-in Royalties

A contractual substitute for actual production

Why is this basic concept important?

Requirements will vary by lease and will be strictly enforced

SHUT-IN ROYALTY CLAUSE

Typical Shut-in Royalty Clause

“When a market at the well for the gas produced from the leased land does not exist, Lessee may suspend operation of such gas well and during such suspension pay to the Lessor in advance an amount equal to one dollar per acre for the acreage held under this lease”

SHUT-IN ROYALTY CLAUSE

Broad Shut-in Royalty Clause (Old Lease)

“Lessee shall not be bound to ... operate on said demised premises when the market price of oil is less than sixty cents per barrel of forty-two gallons each, at the wells or in the immediate vicinity”

SHUT-IN ROYALTY CLAUSE

The Shut-In Royalty Checklist with Many Pitfalls

1. Does the lease contain a shut-in royalty clause?

Yes → Proceed to step 2

No → STOP (cannot imply a shut-in royalty clause)

2. Scope includes oil?

Yes → Proceed to step 3

No (gas only) → STOP (remember, based in contract)

SHUT-IN ROYALTY CLAUSE

The Shut-In Royalty Checklist with Many Pitfalls

3. Reason for shut-in? **Must fall within the scope of the clause.**
4. Is the well capable of producing in paying quantities?

A word of warning: waiting to shut-in may harm your ability to keep your lease alive and prevent reliance on the shut-in royalty clause

THANK YOU

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