HOLLIDAY ENERGY LAW GROUP

Texas' Production in Paying Quantities

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Through our San Antonio office, HEL provides a full range of title services ranging from acquisition/due diligence to preparation of division order title opinions for operations in Texas, Oklahoma, North Dakota, Ohio, Illinois, and Nebraska.

OVERVIEW

- In Texas, production = production in paying quantities (implied)
- General Rule: Production in paying quantities means that gross operating revenues must exceed your operating expenses
- Texas Supreme Court established a 2-Part PPQ Test in Clifton v. Koontz

OVERVIEW

- PPQ is determined by the Clifton v. Koontz 2 Part Test
  - **Test 1**: Is Income from Production > Marketing + Operating Expense?
    - If Yes – PPQ is present. No further inquiry / If No – Move to Test 2
  - **Test 2**: Would a Reasonably Prudent Operator, under the specific circumstances, continue to operate the well in the manner it was operated for the purpose of making a profit and not speculation?
- Party alleging that lease has expired for lack of PPQ has Burden of Proof
- No finite time period that demonstrates lack of profitability

The Basics – Texas Oil & Gas Lease is a Fee Simple Determinable Grant

- In Texas, an OGL is a Fee Simple Determinable grant (FSD)
- In FSD, the estate granted (leasehold) will end automatically when the stated event or condition (lack of production) occurs.
- TX Lessee receives a fee simple determinable grant of the mineral estate for a term of years, and so long thereafter as there is either production or a negotiated substitute
- TX Lessor retains a negotiated royalty interest (known as the participating royalty, or lease royalty) and the right of reverter
- Upon the pre-determined condition – for OGL a lack of production following the end of the primary term – the mineral estate automatically reverts to the grantor/lessor or her heirs and the lease terminates

The Basics – OGL's Habendum Clause Fixes Duration of Grant

- Habendum Clause (HC) is the portion of the instrument that tells us how long FSD grant lasts
  - *Note that the HC is impacted by other provisions in OGL (e.g. substitutes for production in secondary term)*

- "…this lease shall remain in force for a term of three (3) years from this date (called "primary term"), and as long thereafter as oil, gas, or other mineral is produced from the leased premises or land pooled therewith, or this lease is maintained by virtue of some other provision hereof."

- HC creates two distinct terms – PRIMARY and SECONDARY terms

The Basics – Two Distinct Terms of the OGL HC - Primary and Secondary Terms

- **Primary Term** – Fixed term established by OGL

  "…this lease shall remain in force for a term of __three (3)__ years from this date…"

- **Secondary Term** – Following expiration of primary term, OGL must be perpetuated by production or a valid substitute

  "… and as long thereafter as oil, gas or other mineral is produced from the leased premises…"

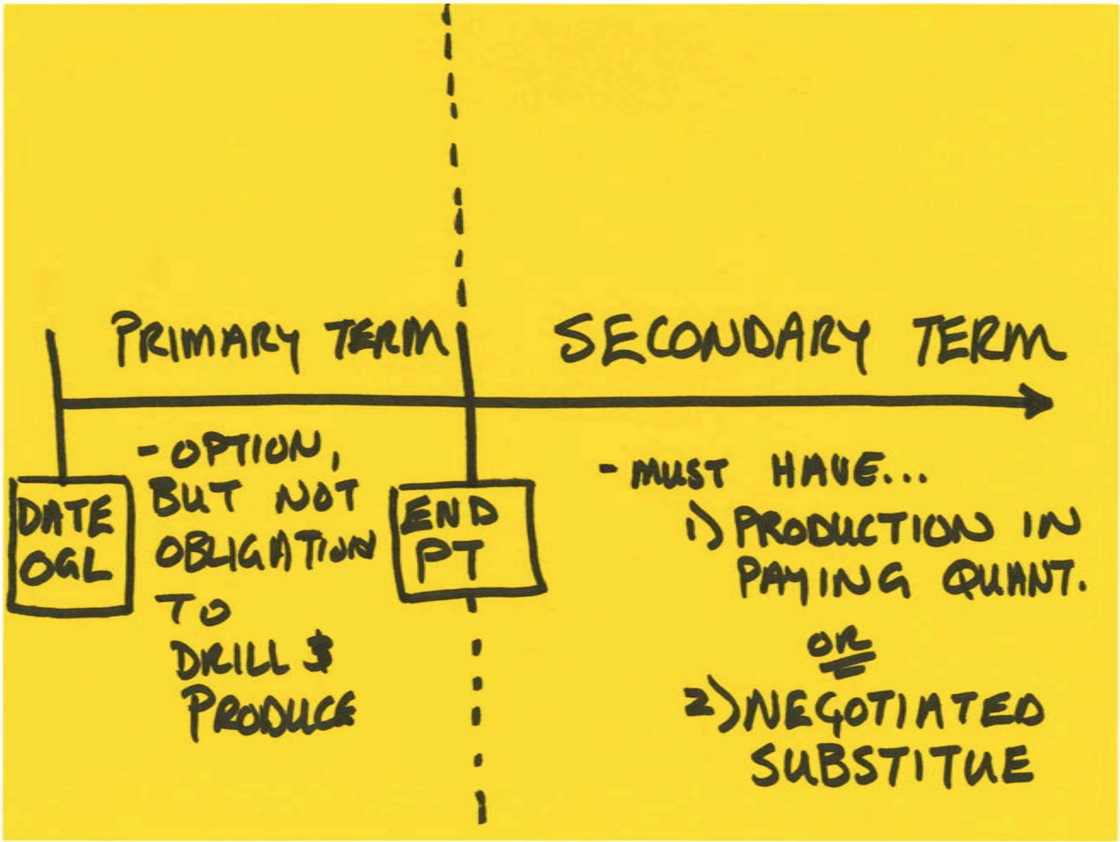
The Basics – Two Distinct Terms of the OGL HC - Primary and Secondary Terms

- Timeline reflects the business deal underlying the OGL *(Shade & Blackwell)*

  - During **PRIMARY TERM**, Lessee wants the option, but not the obligation, to explore

  - If production is established, Lessee wants to hold the lease into the **SECONDARY TERM** as long as profitable to maximize returns on investment, whether or not the well ultimately 'pays out'

The Basics – HC Creates OGL's Primary and Secondary Terms



The Secondary Term

- Many ways to perpetuate lease into Secondary Term common to TX OGLs outside of production
  - Continuous Development operations across end of PT
  - Shut-In Royalty
  - Force Majeure

- TX HC generally states that following the end of the primary term, OGL will last ‘so long thereafter as oil and gas are produced from the lands’
  - *Must have either Production or a Substitute for Production to maintain lease into secondary term*

The Secondary Term – Meaning of Production in Texas

- What does “Production” mean?

  - **Majority Rule (Texas)** – Production means that oil/gas is being actually produced and marketed
    - We’re extracting oil and gas out of the ground AND we’re selling it

  - **Minority Rule (Oklahoma)** – Production means ‘capable of production’
    - The well could produce, but isn’t necessarily for any number of reasons

The Secondary Term – Meaning of Production in Texas

- **HYPO:** XYZ Oil & Gas completes a well during the PT that is capable of producing high volumes of natural gas. Unfortunately, the nearest pipeline is over 60 miles away. There is no way to produce the well until at least a gathering line is laid.

  - **Oklahoma:** Lease is maintained into secondary term because well is capable of production.

  - **Texas:** OGL would expire at the end of the PT for lack of production ***UNLESS*** a specific substitute for production – i.e. a Savings Clause – addressed the situation.

Hypothetical From Primer on Texas Oil & Gas by Shade & Blackwell

The Secondary Term – Impact of Savings Clauses on HC

- HC is harsh in it's application – binary yes or no – we're producing and selling or we're not
- Savings Clauses Modify/Mitigate the HC
  1. Provide ways for OGL to survive after the primary term has expired, but where there is not actual production being sold
  2. Known as Constructive Production
  3. Negotiated substitutes for production that will keep the OGL alive in certain common and foreseeable circumstances
- Examples: Force Majeure, Continuous Development, Shut-In Royalty, Re-Work provisions

The Secondary Term – How Much Production Do We Need?

- Is not enough to simply produce and sell oil/gas
- Must have **<u>Production in Paying Quantities</u>**
- In Texas, courts interpret “Production” to mean “Production in Paying Quantities”
  - When you see production, it means ‘production in paying quantities’

- **<u>RULE</u>: In order to preserve OGL into the secondary term, lessee must have production in paying quantities (or a valid substitute therefore)**

Production in Paying Quantities

Production in Paying Quantities = Operating Revenue > Operating Expenses over a reasonable amount of time

- Reflects the underlying business deal – to produce profitably
- If production isn't profitable, the FSD grant should end

Production in Paying Quantities – Basic Example

- **HYPO:** ABC Resources operates the Oro Negro #3 well, which currently produces 10bbl/mo. Production is marketed at $68/bbl.
  - 10bbl/mo x $68/bbl = Operating Revenue of $680/mo
  - ABC has operating expenses of $800/mo.
  - Net Loss of $120/mo
  - Would this lease expire for lack of production in paying quantities?
  - Maybe… Look to the Clifton v. Koontz 2 Part PPQ Test

Production in Paying Quantities – Clifton v. Koontz Two Part PPQ Test

- **Clifton v. Koontz:** Texas Supreme Court adopts the two-part PPQ test

  - **Part 1: Accounting Test – Does Operating Revenue > Operating Expense?**
    - If YES – PPQ is established. Inquiry Over.
    - If NO – Proceed to Part 2 – RPO Test
  - **Part 2: Reasonably Prudent Operator Test** – Would a reasonably prudent operator, for the purpose of making a profit and not mere speculation, continue to operate the well at a loss under the same circumstances?
- **Burden of Proof** - Party alleging that a lease has terminated due to a lack of production in paying quantities has burden of proof

PPQ Test – Part 1: Accounting Test

- **Part 1: Accounting Test – Asks does Operating Revenue > Operating Expense?**
  - If YES – PPQ is established. Inquiry Over.
  - If NO – Proceed to Part 2
- Accounting Test looks back in time at what has occurred previously
- Sufficient if the well "pays a profit, even small, over operating expenses," Clifton v. Koontz

PPQ Test – Part 1: Accounting Test

- “Well Payout” is **not** the standard

- Profit on total investment is not required
  - No requirement that lessee demonstrate that the original capital investment will be recovered – Acquisition, Drilling, Completion Costs

- Encourages exploration because allows Lessee to recoup as much investment as possible
  - Rule allows lease to continue to produce even though well may never “pay out”

PPQ Test – Part 1: Accounting Test

- Favors continued production from marginal wells
    - This is in keeping with Texas oil and gas jurisprudence and regulatory approach that encourages exploration
- Grants considerable deference to the operator

PPQ Test – Part 1: Accounting Test – What is Operating Revenue?

- **Operating Revenue** = All income attributable to the working interest
  - NRI
- Operating Revenue DOES NOT include landowner royalty
  - Participating Royalty
  - Non-Participating Royalty
- Very few cases address this issue

PPQ Test – Part 1: Accounting Test – What is an Operating Cost?

- **Operating Costs** = Periodic cash expenditures incurred in the daily operation of a well
  - Consistent and repeated costs
  - Aka Lifting Costs

- These include…
  - Taxes (Ad Valorem, Severance)
  - Labor
  - Pumping
  - Repairs
  - i.e. What it costs to keep the well going

PPQ Test – Part 1: Accounting Test – What is an Operating Cost?

Overhead Charges **<u>tied to the specific well</u>** CAN BE CONSIDERED operating costs, BUT….

- **CAUTION:** District or area wide administrative expenses ARE NOT considered operating costs where they would be incurred whether or not the particular well in question was produced. <u>Ladd Petroleum v. Eagle Oil and Gas Co.</u>, 695 SW2d 99 (Tex. App. Fort Worth 1985), writ refused n.r.e. (Jan. 15, 1986)
- **Guiding Principle:** Administrative and supervisory expenses should be allocated to a well ONLY to the extent that they would be reduced by eliminating the well in question.
- PROCEED WITH CAUTION IN ASSESSING OVERHEAD CHARGES

PPQ Test – Part 1: Accounting Test – What is an Operating Cost?

- Depreciation
  - Actual Depreciation on salvageable equipment is an operating cost
    - UNLESS it was included as part of the original drilling and completion costs, Bates v. Delhi-Taylor Oil Corp., 362 SW2d 388 (Tex. Civ. App. San Antonio 1962)
    - NOTE: Permissible amount of this is likely to be small

- Outstanding ORRIs
    - Clifton v. Koontz, 160 Tex. 82, 325 SW2d 684, 79 A.L.R.2d 774 (1959); Morgan v. Fox, 536 SW2d 644 (Tex. Civ. App. Corpus Christi 1976), writ refused n.r.e. (Oct. 6, 1976)

PPQ Test – Part 1: Accounting Test – What is an Operating Cost?

- Additional Texas cases discussing operating costs for PPQ Analysis
  - Evans v. Gulf Oil Corp., 840 SW2d 500 (Tex. App. Corpus Christi 1992), writ denied, (April 14, 1993);
  - Pshigoda v. Texaco, Inc., 703 SW2d 416 (Tex. App. Amarillo 1986), writ refused n.r.e. (May 28, 1996)

PPQ Test – Part 1: Accounting Test – What is NOT an Operating Cost

- Non-Operating Costs = CAPITAL EXPENDITURES
  - These are not considered as costs against revenue in a PPQ analysis
  - One-time investment expenses
  - Drilling, Completion, and Equipping the Well
    - Clifton v. Koontz, 160 Tex. 82, 325 SW2d 684, 79 A.L.R.2d 774 (1959); Peacock v. Schroeder, 846 SW2d 905 (Tex. App. San Antonio 1993); Evans v. Gulf Oil Corp., 840 SW2d 500 (Tex. App. Corpus Christi 1992), writ denied, (April 14, 1993);
  - Re-Working Costs
    - Abraxas Petroleum Corp. v. Hornburg, 20 SW3d 741 (Tex.App. El Paso 2000); Peacock v. Schroeder, 846 SW2d 905 (Tex. App. San Antonio 1993); Pshigoda v. Texaco, Inc., 703 SW2d 416 (Tex. App. Amarillo 1986), writ refused n.r.e. (May 28, 1996)
  - Depreciation on original investment costs
    - Clifton v. Koontz, 160 Tex. 82, 325 SW2d 684, 79 A.L.R.2d 774 (1959)

PPQ Test – Part 2: Reasonably Prudent Operator Standard

If Operating Expense > Operating Revenue….

Then we move to 2nd inquiry – the RPO Test

PPQ Test – Part 2: Reasonably Prudent Operator Standard

- **Part 2: Reasonably Prudent Operator (RPO) Test -** Would a Reasonably Prudent Operator, for purposes of making a profit and not for mere speculation, continue to operate the well in the same manner under the same circumstances?
- Part 2 is a forward looking question of fact for the jury
- Fact intensive look at the specific circumstances involved

PPQ Test – Part 2: Reasonably Prudent Operator Standard

- **Part 2: Reasonably Prudent Operator (RPO) Test - 3 Parts**

Would a Reasonably Prudent Operator….

1. for purposes of making a profit and not for mere speculation,
2. continue to operate the well
   1. in the same manner?
   2. under the same circumstances?

PPQ Test – Part 2: Reasonably Prudent Operator Standard

- RPO Test assumes some actual physical production
- Not applicable where there is a total lack of production
- For total lack/lapse in production, operator must look to OGL for an adequate savings clause
  - E.g. Shut-In Royalty, Temporary Cessation Clause, Re-working provisions, etc.
- Essentially we're asking – Is what is happening reasonable?

PPQ Test – Part 2: Reasonably Prudent Operator Standard

- RPO Factors to Consider
  1. Reservoir depletion
  2. Price obtained for product
  3. Relative profitableness of wells in the area
  4. Operating and marketing cost trends
  5. Reasonable considerations about commodity price environment and future expectations

Timeline for Determining Production in Paying Quantities

- MAJOR ISSUE: Over what period of time is production in paying quantities determined?
- NO BRIGHT-LINE RULE
- TX SCT has made clear that unless specifically determined by the OGL, a well's profitability is not determined by looking at a specific accounting period
- Determination will be fact-specific to the particular case

Timeline for Determining Production in Paying Quantities – BP America Production Company v. Laddex, 513 SW3d 476 (2017)

- Texas Supreme Court
- FACTS:
  - BP has a well that produced for years.
  - Production sharply declined for 15 months, after which well was re-worked and resumed constant production.
  - 1 year later, mineral owner top-leases.
  - Top-lessee files suit, alleging BP lease expired for lack of PPQ during 15 mo. period.
  - Jury is instructed to consider PPQ only as to 15mo of low production.
- District Court: Judgment for Top Lessee. Lease expired for failure to PPQ during 15 month period.
- Court of Appeals: Reversed judgment; trial court erred in limiting jury's profitability consideration to a specific time period

Timeline for Determining Production in Paying Quantities

Texas Supreme Court upholds Court of Appeals

1. No specific timeline is to be considered by jury
   1. "There can be no limit as to time, whether it be days, weeks, or months, to be taken into consideration in determining the question of whether paying production from the lease has ceased." Clifton v. Koontz, 325 S.W.2d at 690.
   2. BP v. Laddex Jury instruction was in error because it limited PPQ consideration only to a specific period.
   3. Parties are allowed to influence the jury's focus to a specific timeline through arguments, but jury may not be instructed to consider a specific time-period

Timeline for Determining Production in Paying Quantities

- Dreher v. Cassidy Ltd. Partnership, 99 SW3d 267 (Ct. Appeals – Eastland 2003)
- Lessor produced evidence that lease failed to PPQ for eight (8) month period, but produced no evidence as to why the eight month period was unreasonable.
- Holding for Lessor – 2nd prong of Clifton test not met.
- Evidence of an 8-month period where Op.Exp.>Op.Rev. not conclusive

Timeline for Determining Production in Paying Quantities

- TIMELINESS TEST = RPO TEST
- Test is whether a reasonably prudent operator have continued to produce the well for same time period in the same way with an expectation of a profit
  - A reasonably prudent operator does not mean the party alleging lease termination
  - Party alleging lease termination must demonstrate that the manner and time period were unreasonable in terms of seeking profit, but rather were geared towards mere speculation of future profits
- This means – “What can you convince a jury of?”

Timeline for Determining Production in Paying Quantities

- No clear point at which lease terminates for lack of PPQ
  - Operator is continuing to produce something, unlike in temporary cessation of production issue
  - Fact issue for jury to decide if that production is enough based on reasonableness inquiry
- Adverse Possession of Leasehold Estate
  - <u>Natural Gas Pipeline Co. v. Pool</u>, 124 SW3d 188 (2003)
  - Lays out arguments for acquiring leasehold estate by adverse possession after a lease has ‘terminated’ despite ongoing production
  - Applicable to claims of termination due to lack of PPQ 3+years prior

PPQ Test – Burden of Proof is on Party Alleging Lease Termination

TX SCT in Clifton v. Koontz makes clear that the party alleging lease termination for lack of production in paying quantities (plaintiff) has the Burden of Proof on both prongs of Koontz Test

"Whether a well is producing in paying quantities is a question of fact for the jury, and the burden is on the lessor to prove a lack of such production in order to terminate the lease." <u>BP America Production Company v. Laddex</u>, 513 SW3d 476 (2017)

PPQ Test – Burden of Proof is on Party Alleging Lease Termination

- TX SCT in Clifton v. Koontz makes clear that the party alleging lease termination for lack of production in paying quantities (plaintiff) has the Burden of Proof on both prongs of Koontz Test
- Plaintiff must plead and prove…
  - Well costs more to operate than it makes,
    - If well is profitable (excluding initial capital investment, such as acquisition, drilling, completion), plaintiff cannot prevail

    AND
  - RPO under all relevant circumstances would have P&A'd the well, i.e. not continued to operate the well for purposes of a profit

Summary – Production in Paying Quantities Considerations in Texas

- Production means that oil/gas is actually being produced and marketed
- Production means “production in paying quantities” whether lease says so or not
- PPQ is a Question of Fact for the Jury
- Two Part PPQ Test
  - Part 1 – Accounting Test = Is Operating Revenue > Operating Expense?
    - IF YES – Inquiry over
    - IF NO – Proceed to Part 2
    - Operating Costs = Taxes, Overhead, Labor, Repairs, Actual Depreciation on Salvageable Equipment, ORRIs
      - Periodic cash payments incurred in the daily operation of a well
    - Not Operating Costs = Drilling, Completion, District Wide Overhead, Reworking, Depreciation on Original Investment Costs
      - One-time investment expenditures; capital expenditures
  - Part 2 – Reasonably Prudent Operator Test = Would a RPO for purposes of profit and not speculation continue to operate the well in the same manner under the same circumstances?
    - Question of Fact for Jury
  - Party alleging lease termination has Burden of Proof
- No specific timeline for determining PPQ

QUESTIONS?

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