

# PRODUCTION IN PAYING QUANTITIES (TEXAS)

**TEXAS OIL & GAS LEASE IS A FEE SIMPLE DETERMINABLE GRANT. THE DURATION IS GOVERNED BY THE HABENDUM CLAUSE, WHICH HAS TWO TERMS: THE PRIMARY TERM AND SECONDARY TERM.**

**Primary Term** = Fixed term of years.

**Secondary Term** = If production or a substitute is obtained during the primary term, the lease remains valid for so long as oil and gas are produced in commercial quantities or a negotiated substitute is present.

Reflects nature of the underlying business deal. Operator has a negotiated period of time to develop, and if it expends capital to drill a well, it should be allowed to maximize returns by producing the well for so long as it makes economic sense to do so.

## PRODUCTION MEANS BOTH:

**1. Actual Production** = Hydrocarbons are actually being produced and sold. If no actual production, then must rely upon a negotiated substitute to keep lease alive in the secondary term.

- Substitutes for production: Continuous Development, Shut-In Royalty, Force Majeure, Re-Work, etc.

**2. "Production in Paying Quantities"** = Simple fact of production is not enough.

- Term of Art. When see word production, means 'production in paying quantities'
- CAUTION: Lease can expressly provide otherwise. Parties may contract as they see fit and be bound by their agreements.

## HOW DO WE DETERMINE IF A WELL IS PPQ?

### Who decides?

- PPQ is a Question of Fact for the Jury
- Party alleging that the lease has terminated for failure to PPQ has the burden of proof
- Texas Supreme Court in **Clifton v. Koontz** 325 S.W.2d 684 (Tex. 1959) provided a Two Part Test to determine whether a well is producing in paying quantities.

## KOONTZ TEST: PART 1

### ACCOUNTING TEST = Is Operating Revenue > Operating Cost?

- Looks back in time.
- IF YES - Inquiry over. Well is PPQ.
- IF NO - Proceed to Part 2

### HOW DO WE CALCULATE?

#### 1. Operating Revenue = Net Revenue Interest

#### 2. What are Operating Costs?

- Operating Cost = Consistent and repeated costs of operating the well.
- Taxes, Overhead, Labor, Repairs, Actual Depreciation on Salvageable Equipment.
- What it takes to keep the well going.

#### 3. What Are Not Operating Costs? One-time investment/capital expenditures

- Drilling, Completion, District Wide Overhead, Reworking, Depreciation on Original Investment Costs

#### 4. "Well Payout" is not the standard

- No requirement to prove that the well will ever 'pay out'
- Texas legal and regulatory policy is to encourage exploration. Allowing marginal wells to continue to produce and operators to recoup some of the costs encourages further exploration.

ACCOUNTING  
TEST

# KOONTZ TEST: 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?


**1. Looks forward and asks** – Would a reasonably prudent operator keep doing this in order to make a profit? Is it reasonable under the circumstances to keep operating this particular well the way we are doing so?

**2. Question of Fact for a jury, and party alleging lease termination has Burden of Proof.**

- Must demonstrate that the manner and time period were unreasonable in terms of seeking profit, and instead show that operations were geared toward mere speculation of future profits.
- Key Factor - Is there a clear line of sight to profitability that doesn't solely depend on rising commodity price?
- Factors that you can consider:
  - Reservoir depletion
  - Spot price
  - Relative profitability of other wells in the area
  - Operating and marketing cost trends

**3. No specific timeline for determining profitability.**

Highly fact-intensive. This will be up to the parties at trial. Jury cannot be instructed to consider only a specific period.



**REASONABLY  
PRUDENT  
OPERATOR  
TEST**

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