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

ACCOUNTING TEST

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, ORRIs.
- 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.

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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

HOLLIDAY ENERGY LAW GROUP

Holliday Energy Law Group PC is an energy law firm focused on advising exploration and production companies in their operations across the United States. We actively engage with our clients throughout all stages of a drilling program, from acquisition through drilling, and eventually to divestiture.

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