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Surviving Low Oil Prices (Part 6) Production in Paying Quantities

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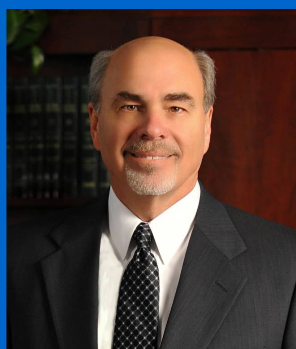

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"Survivor" is not Just a Show

Pain in the oil and gas industry continues, and is now starting to spill over to others that rely on or serve the industry. It is starting to feel like we have been thrust into a reality show about *Survival*, and only a few will make it out unscathed. In my mind, we could fit into any of the following survival shows currently airing:

The Walking Dead
Naked and Afraid
Beyond Survival
Fear
Alone [at Home]
Life Below Zero [Prices] – My Favorite

What name would you give to a show about these times of survival? There are many!

Despite promised cuts in May production by OPEC+, the WTI price today opened down $4.15 to $12.79/Bbl. and natural gas was down to $1.608/MMBtu. The severity of damage to the energy industry became obvious on April 20, when WTI (the benchmark price of U.S. oil futures) plunged to below zero, for the first time in history, to an unthinkable minus $38 a barrel. And as you recall, casinghead gas prices in the Permian Basin were negative not long ago. Did any of us ever imagine that a producer may have to pay someone to take oil or gas off his hands – a negative value? Every day we read of more troubles and possible solutions (which have not worked yet). Until market demand returns, there is little we can do but try to survive.

This downturn is not only about survival of the companies we work for, but also the survival of our jobs and communities. The oil capital of the world - Houston, TX - has started feeling the impact already. The Houston mayor announced that city employees would soon be furloughed, but he declined to say how many. The Houston Zoo could also expect to see funding deferred under what the mayor called "*the worst budget that the city will deal with in its history*." It is critical that we review any and all way to cut costs and still survive in these times of catastrophic decline in the market. These survival tactics impact not only the energy industry, but also our communities and all those that feed off the industry.

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The continued drop in oil prices is connected to the fact that worldwide oil storage facilities are filling rapidly, raising concerns that production cuts will not be fast enough to catch up with the collapse in demand from the coronavirus pandemic. It has been reported that US crude inventories recently rose to 518.6 million barrels, near an all-time record of 535 million barrels set in 2017, while floating tankers carrying crude oil storage has hit an all-time high of 160 million barrels.

As mentioned in Part 1 of my article, oil and gas companies generally need oil at $40 - $50 Bbl. to cover operating expenses and make a small profit. New drilling is barely economic at those levels. Each field has different economic pressures, but with oil prices in the $20/Bbl. range (or below), many producers will not only struggle to meet operating expenses, but have to adapt to even stay alive (or out of bankruptcy) and keep their leases from lapsing for lack of production in paying quantities.

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Since the price of oil is certain to stay low until market demand increases back to pre-Covid-19 levels, it has become apparent that the US producer must find ways to adapt to this hopefully short-lived depressed market. Government is examining ways to help, but that is likely not going to provide the entire answer. New Mexico and Oklahoma have recently announced rules to allow operators to temporarily shut-in, without loss of lease. The Texas Railroad Commission (*TRRC*) held a hearing but appears to be against forced reduction of production allowables. Others have announced deferrals in severance or royalty payments. But prices continue to drop.

In this article we will take a look at the general rules governing maintenance of the mineral lease by production in "paying quantities." For purposes of this article, we will assume that production continues, even if curtailed, and that the wells(s) are not totally shut in. That is, the lease is being held by production of some volume.

Held by Production ("HBP")

What is "Paying Quantities" Production

If a mineral lease is not being maintained by rental payments, it can be maintained (or held) by continuous operations or production. If the lease is being held by production, commonly called "HBP", a minimum amount of production is required for lease maintenance. This minimum amount of production is referred to as "paying quantities." Today we will examine the requirements for a lease to be HBP in "paying quantities."

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Some mineral leases contain an express provision defining "paying quantities." If a lease provision actually defines "paying quantities," that provision will likely be applied as the agreement of the parties. The first rule, therefore, is to examine your

lease to confirm whether or not a definition of "paying quantities" is written in, or if some other amount of production (or royalty payments) is expressed for the lease to be HBP.

If your lease does not expressly define the minimum amount of production required for paying quantities, the applicable state law will define what is required. Most producing states will read in a requirement that production be in "paying quantities", even if not expressed in the lease. In Louisiana, Mineral Code Articles 124 and 125 (LRS 31:124 & 125), codify the rule that production must be in paying quantities, as follows:

"It is considered to be in paying quantities when production allocable to the total original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss..."

> §124. *Production in paying quantities required; definition:*
>
> When a mineral lease is being maintained by production of oil or gas, the production must be in paying quantities. It is considered to be in paying quantities when production allocable to the total original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss....
>
> §125. *Amount of royalties relevant to reasonableness of lessee's expectation:*
>
> In applying Article 124, the amount of the royalties being paid may be considered only insofar as it may show the reasonableness of the lessee's expectation in continuing production. The amount need not be a serious or adequate equivalent for continuance of the lease as compared with the amount of the bonus, rentals, or other sums paid to the lessor. *(This somewhat modified prior Louisiana case law)*

Louisiana has essentially adopted the TX test announced in the 1959 case of Clifton v. Koontz

The Louisiana Mineral Code articles essentially codify the "paying quantities" test adopted by the Texas Supreme Court in the famous 1959 case of *Clifton v. Koontz*, 325 S.W. 2d 684 (TX 1959). Consequently, even if a Louisiana mineral lease does not expressly require it, the phrase "paying quantities" is read into the lease requirement for HBP.

What Costs are Included in the Determination

...the working interest owner(s) must receive enough money out of production sales to cover "direct" operating expenses, plus a small profit.

There is no automatic test (since based on reasonableness), but there are certain rules that courts have adopted to give light to the requirement. So, what costs are included in the calculation and how much money has to be made to be HBP in "paying quantities"? The answer in Louisiana, and several other states, is that the working interest owner(s) must receive enough money out of production sales to cover ***"direct" operating expenses***, ***plus a small profit***.

The overriding purpose of the rules governing "paying quantities" is that an operator cannot continue to produce for long without a small profit, and merely hold the lease for speculative purposes.

The following rules have been established by our courts for a determination if production is in paying quantities: (a) Lifting costs for labor (such as the pumper), consumed materials or chemicals, trucking (for saltwater disposal), ad valorem taxes and other recurring expenses (such as electricity) are included in costs that must be covered, (b) Capital expenditures or nonrecurring costs do not have to be covered, meaning that costs for drilling, completion, workovers, overhead, depreciation of equipment and similar expenses are not included in the calculation; (c) The amount of "small profit" to be received is not a mechanical test, but must be sufficient to induce a reasonably prudent operator to continue operations; (d) The well can be HBP in "paying quantities" even if the well will never payout; (e) The amount of lessor's royalty paid must be sufficient to confirm that the lessee is not simply holding the lease for speculation (i.e., future unknown discoveries); (f) The future expectations for prices to be received for production can be a factor if an extreme market is reasonably expected to return to normal. The overriding purpose of these rules, and others, governing "paying quantities" is that an operator cannot continue to produce for long periods of time without a small profit, and merely hold the lease for speculative purposes.

Will a Temporary Loss Cancel my Lease?

12 to 18 Month Rule

... if low or negative prices continue, how long can a lessee keep its lease alive pending a return of higher prices and production in paying quantities?

Obviously, a lease cannot be in "paying" quantities if prices are negative (below $0, as occurred recently for oil and gas) or extremely low. So what does a producer do when having to pay to dispose of production (negative prices), or if prices are so low that direct operating expenses are not being recouped? In these instances, the lease is in a "loss" position and absent some speculation the operator could not continue to stay in business if these low (or negative) prices remained in effect for a long time. So, if low or negative prices continue, how long can a lessee keep its lease alive pending a return of higher prices and production in paying quantities?

The rule in Louisiana, like many other producing states, is that the court will use a 12 to 18 month period to evaluate whether or not a mineral lease (or well) is producing in "paying quantities."

The rule in Louisiana, like many other producing states, is that the court will use a **12 to 18 month period** to evaluate whether or not a mineral lease (or well) is producing in "paying quantities." This rule was recently recognized by a Louisiana court in *Gloria's Ranch, L.L.C. v. Tauren Exploration, Inc*., 223 So.3d 1202 (La. App. 2017), which held as follows:

> "Implicit in the term 'paying quantities' is the requirement that the production income exceed operating expenses. *Middleton v. EP Energy E & P Co., L.P.*, (La.App. 2 Cir. 02/03/16), 188 So.3d 263. Louisiana courts generally use a 12–month to 18-month period to evaluate whether or not a well is producing in paying quantities. See *Wood v. Axis Energy Corp*., (La.App. 3 Cir. 04/06/05), 899 So.2d 138 (12–month period

used); *Edmundson Bros. P'ship. v. Montex Drilling Co.* , 98-1564 (La.App. 3 Cir. 05/05/99), 731 So.2d 1049 (18–month period used) ; and *Menoah Petroleum, Inc. v. McKinney* , (La. App. 2 Cir. 1989) 545 So.2d 1216 (12–month period used)."

> *The court [in the Gloria's Ranch decision] ...ruled that "the existence of an ongoing business plan to develop the Haynesville Shale does not exempt the defendants from the requirement that production be in paying quantities."*

In the *Gloria's Ranch* case, the plaintiff's expert testified that each of the three producing wells on the lease cost more money to operate than revenue generated between July 2008 and December 31, 2009. During this 18-month period, the three wells lost $85,743.41, $70,837.10, and $59,927.08, respectively, for a total cumulative net loss of $216,507.59 in the 18-month period. The court ruled that since the lease had not been in paying quantities for 18 months, the lease automatically terminated. Also important was the recognition by the court that the existence of a "business plan to develop the Haynesville Shale" did not exempt the defendants from the requirements of production in paying quantities. In other words, unprofitable wells producing from shallow zones cannot keep the lease HBP for the speculative purpose of hoping that a deeper zone (the Haynesville) may be proven productive in this area.

Do Market Conditions Matter

> *Louisiana courts have indicated that the economic state of the energy industry is relevant in determining whether the lessee is producing in "paying quantities."*

The short answer should be "yes." Louisiana courts have indicated that the economic state of the energy industry is relevant in determining whether the lessee is producing in "paying quantities." In a case not designated for publication, the court found that the "*trial judge correctly pointed out that another valid factor to be considered in determining whether there has been production in paying quantities is 'the serious down flux of production during this period*,' apparently referring to the state of the economy in the oil and gas industry during the period in which lessor claims there was failure to produce in paying quantities." *Blanchard v. Atlantic Richfield Co*., Docket No. 89-CA-1283 (La. App. 1st Cir. 1991) There are a few other cases have similar findings, that a severe economic downturn in the industry is temporary and does not automatically result in termination of a mineral lease because of temporary losses sustained by the operator. No doubt we will see more litigation on this issue in 2020 or 2021.

> *...as long as this downturn and unprofitable operations do not exceed 12 to 18 months, an operator that is in good faith (and not merely holding on to speculate) should be in good standing here in Louisiana and states having similar requirements.*

We are clearly living through one of the most unusual and unforeseen times in modern history. If these impossible economic hardships and uncertain times do not trigger a legal basis for suspending or extending "paying quantities" requirements, then I'm not sure what would. In any event, as long as this downturn and unprofitable operations do not exceed 12 to 18 months, an operator that is in good faith (and not merely holding on to speculate) should be in good standing here in Louisiana and other states having similar requirements. As mentioned earlier in this paper, be sure to check your applicable lease for any requirements or other time period specified for a paying quantities determination.

It may be a wise strategy in these times of historically low commodity prices to consider shutting-in production, cutting your losses (and your royalty owner's) and awaiting a rise in prices, as discussed in prior articles. However, if an operator continues to produce its wells, either at full stream or curtailed volumes, then the operator must (a) examine all lease terms to determine if the lease defines paying quantities or other related terms for the lease to be HBP; (b) If no applicable lease provisions, review the law to confirm that "direct" operating costs, plus a small profit, is required to be in paying quantities, (c) confirm the 12 to 18 month rule applies to its particular situation; and (d) verify that it is not holding a non-profitable lease merely for speculative purposes.

Next Issue:

In the next issue we will examine US Tariffs to combat illegal dumping of oil on the market and other issues arising in this tumultuous period.

Please feel free to contact me if you have any questions or need additional advice.

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