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## Surviving Low Oil Prices With Domestic Alternatives

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*Like contracts in  
general, a mineral  
lease is the basic law  
between the parties  
and generally regulates  
their respective rights  
and obligations.*

The collapse in global economic activity due to Covid-19 has led to a critical reduction in crude oil demand. Add in excess supply dumped on the market by the production quota battle between the Saudi's and Russia, and it is no surprise that oil prices have fallen to historically low levels. *But that is not the end of the bad news.* Storage facilities that normally hold excess oil production are now rapidly filling up. Russian and the Saudi Arabian officials are scheduled to meet today to explore a deal to stop the production glut, but any agreement would still leave us dependent on the deal falling apart in the future.

If production gluts continue, we may soon reach that point in time when crude storage facilities are at capacity. At that point, oil prices are likely to fall further (possibly into negative territory like natural gas did last year in the Permian) because there will be no place to store the excess oil. That is why we must consider ways to find domestic solutions, and not rely on foreign sources to solve the market glut. The answer could lie partially in President Trump's proposal to open the US Strategic Oil Reserve storage facilities to oil that cannot find a home.

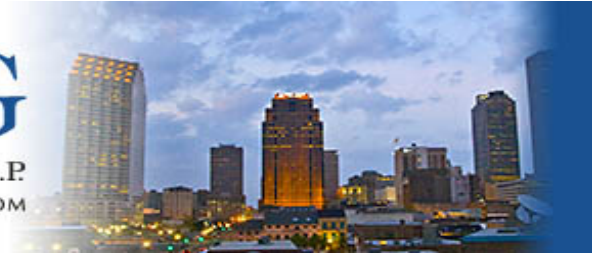
In this issue we will we examine ways to reduce costs by continuing to produce but to defer royalty payments *storing production for later sale* (when commodity prices rise back to economic levels). We will only be looking at lessor's royalty reserved by private mineral owners (not the State or Federal governments). Although this paper discusses only Louisiana law, these concepts may apply in general to other states as well.

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### Can Production be Stored without Triggering Royalty Payments?

A. The Lease provides the Basic "Law for the Parties"

The mineral lease provides the basic rules when deciding when and how royalty is to be paid. Louisiana Civil Code Article 1983 provides that "*Contracts have the effect of law for the parties.*" Also see Mineral Code (MC) Art. 3 and *Stephenson vs. Petrohawk Properties, L.P.*, 37 So.3d 1145 (La.App.2d Cir.6/2/10). These negotiated



provisions only limited by public policy or laws that mandate specific terms. However, to have a full understanding of the mineral lease terms, we must review some terms that are generally defined by law, as discussed below.

B. Royalty is a form of “Rent.”

In Louisiana, our law requires that some form of “rent” or other consideration be given in order to keep the lease alive. Mineral Code (MC) Article 123 provides that “*royalties paid to the lessor on production are rent.*” Our courts have “long regarded production royalties as rent.” *Fuselier v. Estate of Peschier*, 525 So.2d 577 (La. App. 3 Cir, 1988) Rent is to be paid “according to the terms of the contract (the mineral lease) or the custom of the mining industry in question if the contract is silent.” (MC Art 123)

C. “Rent” is different from “Rental.”

Under MC Art 213(4), a “rental” is paid to maintain a lease “in the *absence of drilling ... operations or production.*” A lease “rental” is often referred to as a “delay rental” because it is paid to keep the lease alive while drilling or production is delayed. The primary term for a mineral lease in Louisiana cannot exceed 10 years. If your mineral lease is still within its primary term, one option to explore is whether your lease allows for the cessation of production and payment of a delay rental to maintain the lease without operations or production.


A lease may also be maintained by payments for “constructive production” (e.g., shut-in royalties, minimum royalties), which is included in the definition of royalty (See MC Art 213(5)). The next article will address shut-in payments.

D. Lessor’s Royalty delivered “In-Kind” for Later Sale

Many leases provide that the lessor can take its share of oil “in kind”, meaning that the landowner’s royalty share of production is stored for or delivered to them before sale by the operator. If your mineral lease(s) gives you the right to deliver the landowner’s royalty share “in kind”, it may be an option to store the landowner’s royalty share and then their share can be sold at a later date when requested by the royalty owner.

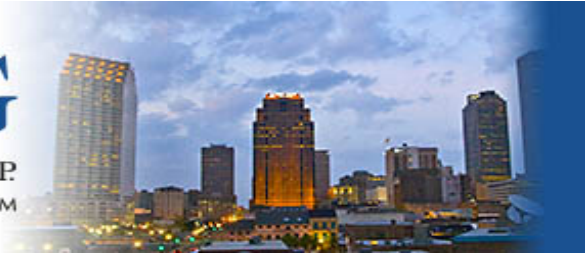
E. “Produced and Saved” vs. “Produced, Saved and Sold”

Although it is becoming difficult to find available storage capacity, oil and gas can physically be stored. Provided there are sufficient storage facilities available, it is possible to produce a well and store production without transacting a “sale”. Before production is stored, the royalty provisions in the lease must be reviewed to determine whether royalty becomes due when “*produced and stored*” or when “*produced, saved and sold.*” There are certainly variations of these clauses, but if the latter type of



Some form of “rent” payment or other consideration is required to keep the lease alive. In Louisiana, royalties are considered a form of “rent”.

If your leases provide for payment when production is “sold”, a viable option may be to store production without transacting a “sale.” The royalty owner would likewise benefit from the higher sales price when it is later taken out of storage and sold.



*Any agreement with the royalty owner should confirm whether the royalty owner will bear any share of related post-production storage or transportation costs.*

*Since you would be deferring a "rent" (royalty is a rent), we also suggest that there be some form of consideration recited for the amendment or deal to suspend payment.*

*In Louisiana, if an owner believes royalty is not being paid as required, they are required to give written demand for payment, as provided in MC Articles 137 – 141.*

*The Lessee has 30 days after receipt of the "required notice" to either "pay the royalties due" or give a written "reasonable cause for non-payment."*

clause is provided in your leases (or approved by the royalty owner), then it may be a viable option to store production without transacting a sale and cease the payment of royalties until the stored production is later "sold". Of course, the royalty owner would benefit from the higher sales price when the production is taken out of storage and sold. One last issue to note, if the lessee pays a storage charge, it is likely that the royalty owner will object to having to share in any portion of this post-production cost, and that should be covered in any agreement with the royalty owner.

#### F. Written Agreement of the Lessor / Royalty Owner

If the lease provides that royalties become due when production is sold (as opposed to saved), it would still be wise to obtain the royalty owner's consent to any storage and deferred payment arrangement. This also applies to any overriding royalty agreement. If the applicable lease or other agreement provides that royalty is due when "produced" or "saved", then before deferring payment you must obtain the agreement of the royalty owners to make payment on the later sale. Any agreement by the royalty owners to this method of deferring payment until production is sold should be in writing and can be accomplished by lease amendment or by a separate short term agreement corresponding to the expected temporary low pricing period. The lease amendment or agreement should also confirm whether the royalty owner will bear any share of related post-production storage or transportation costs. Since you would be deferring a "rent" (royalty is a rent), we also suggest that there be some form of consideration recited for the amendment or deal to suspend payment.

#### G. Legal Demand for Payment of Royalty and Cure Period

In Louisiana, if a mineral owner believes royalty is not being paid as required they are required to give written demand for payment. MC Articles 137 – 141 (**RS 31: 137 – 141**) set forth the applicable laws governing demand and remedies for non-payment. The following procedures are established by the MC, which must be followed in the event a lessor seeks relief for the failure of its lessee to make timely or proper payment of royalties:

1. Art 137 – Written Demand of a "failure" to make proper payment "must" be given by the lessor to the lessee, "as a prerequisite to ... damages or dissolution of the lease."
2. Art 138 – The Lessee has 30 days after receipt of the "required notice" to either "pay the royalties due" or give a written "reasonable cause for non-payment."
3. Art 139 – If the lessee pays or tenders the royalty within 30 days after demand, then "the remedy of dissolution" of lease "shall be unavailable" unless the original failure to pay was "fraudulent."
4. Art 140 – If lessee fails to timely pay or provide a reasonable excuse then the court may award double damages and attorney's fees, plus interest.
5. Art 141 – Dissolution of the lease is not a favored remedy, generally used for fraud or



bad faith. Failure to pay royalty simply because the price is low could be construed as bad faith if the lessee fails to cure the default after receipt of demand.

#### J. Other Issues to Consider

Understanding your mineral leases is just the starting point when considering curtailment of production. Other issues that must be considered include, but are likely not limited to:

- Drilling and production obligations under any applicable “farmout”, development agreement or operating agreement,
- The potential impact on reserve engineering and the lessee’s mortgages, financing agreements or the borrowing base thereunder,
- Objections from co-owners or non-operators that own an interest in the well,
- Delivery obligations or quotas under any production sales contracts, transportation or marketing agreements,
- Impact on any price hedging that may be in place, and any requirements that a certain percentage of well capacity be delivered and
- Potential regulatory rules and production allowables for the curtailed wells or field.

There is no easy answer to any of these issues, and others that may arise from a decision to curtail production. A comprehensive assessment and understanding is needed for the terms of each applicable lease, related contract, financing agreements, price hedges and regulatory requirements.

#### K. “As for me and my house”

If I were your royalty owner, “as for me and my house” we would welcome (if not request) a storage or temporary curtailment plan (including a temporary shut-in). This would maximize royalty dollars on a non-renewable resource until later when prices increase back to normal. However, if your royalty owner objects to a storage plan, if you do curtail production they will be required to give written demand for payment the lessee has 30 days to cure the default by making payment.

In Louisiana, a recent LOGA survey shows that by June 1<sup>st</sup> half of the wells could be shut-in and more than 23,000 industry jobs lost, as reported in a story run on April 7, 2020 in the Baton Rouge newspaper, *The Advocate*. Other producing states are likewise hit hard by this crisis. Cooperation is needed between the mineral owners and their lessees, in addition to governmental support for the industry.

*Understanding your mineral leases is just the starting point when considering curtailment of production. Many other issues must be considered.*

*“As for me and my house” we would welcome (if not request) storage or temporary curtailment in production during this unprecedented period of low prices.*



*In Louisiana, a recent LOGA survey shows that by June 1, half of the wells in the State could be shut-in and more than 23,000 industry jobs lost. Other producing states are not in much, if any, better condition.*

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**Next Issue:**

**What if I just shut-in my wells?**

In the next issue will examine impacts resulting from a decision (or economic necessity) to shut-in wells and shut-in payments on certain, but not all, types of production.

Please feel free to contact me if you have any questions or need additional advise on staying alive in these difficult times for the industry. I am working at home where possible under the Shelter-in-Place Orders. The best way to reach me is on my cell phone or by email.

*Stay safe and (where possible) Stay Home:*

<https://www.youtube.com/watch?v=WIDnkRJGuGw>

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