C. Randall Loewen
(985) 292-2010
(337) 280-6873 (cell)
rloewen@millinglaw.com

Surviving Low Oil Prices (Part 3) Is Shutting-in an Option

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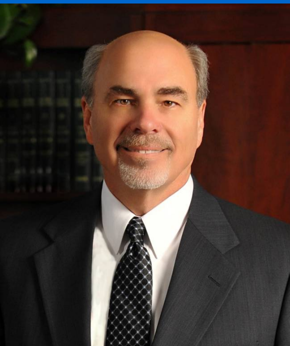

C. Randall Loewen is a partner at

Milling Benson Woodward, LLP

Mandeville, LA - Northshore Office

68031 Capital Trace Row
Mandeville, LA 70471

(985) 292-2010 (direct)
(337) 280-6873 (cell)

rloewen@millinglaw.com

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Don’t Repeat the Mistake of Foreign Dependence

The US Air Force has a bomb named the MOAB, which stands for Mother of All Bombs. You wouldn’t want to be near when it hit. This current oil glut market could appropriately be named the MOAG – ***Mother of All Gluts***. I feel certain all of us in the oil business feel the pain and wish we hadn’t been hit by MOAG.

The health of our industry currently hinges on actions taken by the foreign oil barons, with the US having little control. Hopefully we have learned from the past that we must focus on ways to take more control of the market. For now, at least Russia and Saudi Arabia are talking. Last Thursday, April 9, they agreed to cut production by up to 10 Million Bbl/day. But on Good Friday they announced no cuts unless Mexico would likewise agree. Mexico quickly refused, so it seemed the deal was off. President Trump stepped in and brokered a deal to get Mexico’s agreement (if the US would float Mexico a loan to keep them financially stable).

But all this was not enough to raise the oil price. Initially, on April 9, the promised production cuts sent the published WTI price *down* $2.33/Bbl. to settle at $22.76. After the weekend, on Monday, the price for WTI went down another $0.35, to settle at $22.41, and this morning (April 14) WTI prices slipped further to $21.34. It appears that the market is focused on reduced demand and building oil storage inventories (including full tankers floating on the oceans).

This market instability is summed up by the fact that OPEC+ may cut production by 10MM/d, but global demand has fallen by 30MM/d because of Covid-19 Shelter-in-Place Orders. Further, history reminds us that prior promises to cut production have lead some countries to cheat - overproducing their share and blowing up any agreement. This all reinforces the fact that oil markets will never be “stable” if we leave it to foreign countries to control the market.

All this should remind us of the 1970’s and 1980’s when we were dependent on foreign oil. Back then, the price skyrocketed and US consumers paid billions of dollars more than oil was really worth, setting up the boom and bust cycle. Today, the foreign suppliers are doing just the opposite, over producing to send the price far below what oil is really worth – all with the intent to bust the American Shale

operators and control the market again (my opinion). That is why we must explore various ways to find domestic solutions, and not rely on foreign sources to solve supply and demand issues.

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In the prior issue we examined whether production could be stored for later sale *and royalty payments deferred* (until sold when commodity prices are back to normal). In this issue, we will examine when can an operator totally shut-in its wells, shut-in payments required for lease maintenance and other related contractual obligations. **We will also suggest that the shut-in clause be revised in future leases to cover an "uneconomic market" not just a "lack of market."**

What if I just shut-in my wells?

A. The Lease and Habendum Clause

There was a time when mineral leases did not contain a shut-in clause. Early leases only had a "habendum clause" to specify duration after the primary term expired. For example, a typical habendum clause provides the lease remains in effect after the primary term "*for so long thereafter as oil, gas or other mineral is being produced or drilling operations are being conducted....*" Since early leases did not contain a shut-in clause, each state had to determine if the habendum clause terminated the lease if a well was shut-in for lack of a market. In Louisiana, courts determined that if the lease did not contain a shut-in clause and production ceased because of a lack of market, the lease would terminate – even if the operator was in good faith and doing all they could to maximize value for both the lessor and the lessee. Other states, such as Oklahoma, were more lenient and allowed the lease to continue if the lessee was diligent in seeking to find a market while shut-in.

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B. Shut-in Clause a "Creature of Contract" (Typically for Gas)

To fix the problems caused by a strict reading of the habendum clause, the shut-in clause was added and is now a standard provision in mineral leases. However, there are many different versions of the clause. Some allow wells to be shut-in only for "gas" (including casinghead gas) and not for oil. Other leases had clauses that applied both to oil and gas. A typical shut-in clause today requires that there be a "lack of market or marketing facilities" for gas. Once shut-in conditions are satisfied, a payment must be made for lease maintenance, but the amount varies by contract. Most leases do require that (1) to qualify, at least one well on the lease be capable of producing in paying quantities, as shown by a well test, (2) production cannot be sold because of a lack of market or facilities and (3) a maximum period applies for maintenance by shut-in payment. Any company that is contemplating shutting-in all production should first carefully analyze each lease.

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C. Constructive Production

Louisiana law recognizes that a lease may be maintained by payments for "constructive production" (e.g., shut-in royalties, minimum royalties), which is included in the definition of royalty, as provided in MC Art 213(5).

The shut-in payment covers what is referred to as "constructive production." Louisiana law recognizes that a lease may be maintained by payments for "constructive production" (e.g., shut-in royalties, minimum royalties), which is included in the definition of royalty in Mineral Code (MC) Art 213(5). In *Davis vs. Laster*, 138 So.2d 558 (1962), the court held that a gas well completed as capable of production would maintain the lease beyond its primary term, solely upon the basis of constructive production by virtue of the payment of shut-in royalties. Lease shut-in payments are recognized by law and may maintain the lease without production.

D. Shut-in Royalty vs. Shut-in Rental

A shut-in payment is more appropriately classified as a royalty, as noted in MC Article 213(5). However, some leases call the payment a shut-in "rental", as opposed to a royalty. The classification given in the lease will have consequences. For example, if a "rental" payment deadline is missed, the lease likely terminated. On the other hand, if the lease designates the payment as a "royalty", if the payment is missed then the royalty owner must give written demand for payment and the lessee has 30 days to cure by paying the shut-in royalty.

E. Lack of "Market" vs. Low Prices (an "uneconomic market"?)

In the past, storage was rarely a problem for oil production, but with the mother of all gluts going on now the world is quickly running out of storage for produced oil.

In the mid-1980's a declining market produced arguments between producers and gas pipeline companies over governmental intervention to reduce production allowables. There was a market for gas, it was just at a lower price. The pipelines were trying to use a governmental order to get them out of take or pay obligations under high priced long term contracts. In that situation, the there was plenty of market but only at the lower price.

Today, we are experiencing low prices for gas (around $1.80 MCF) but there is a market – at least for now. As to oil, in the past storage was rarely a problem, but with the mother of all gluts the world is quickly running out of storage for oil. Weekly inventories of oil in storage shows that oil facilities are almost filled to capacity, and if something doesn't change soon we are about to enter uncharted territory of no place to market or store produced oil. Production at current levels questions whether a "viable" market still exists for oil (in addition to paying quantities issues addressed later).

In this historically low price environment for oil, it would benefit both the lessor and lessee to keep production in the ground ... and allow wells to be shut-in during an uneconomic market.

This raises the question of whether an "uneconomic" market qualifies as a "lack" of market that would trigger shut-in situations? In this historically low price environment for oil, it would benefit both the lessor and lessee to keep production in the ground while waiting for prices to increase to economic levels. The short answer is to get your lessor to approve shutting in the wells during an uneconomic market. However, the lessor's consent is not a viable option, the law may provide some relief.

F. A Win-Win Scenario for Uneconomic Times

The shut-in clause was designed to provide the lessee with a way to protect its investment while giving the lessor money pending future production and sale. There is case law in Louisiana recognizing that unusual circumstances can make operations uneconomic and allow shutting-in without loss of lease. This jurisprudence could be presented to justify using the shut-in clause when the market is uneconomic, i.e., when there is a lack of a *viable market*. **Even though some market may exist at historically low prices, an uneconomic market is not any better than no market at all.** It is simply not viable. This reasoning seems sound since the shut-in clause was adopted to keep a good faith lessee from losing its investment, while protecting the lessor (who will receive a shut-in payment now and later a royalty on higher priced sales). A win-win situation for both the lessor and lessee.

There is case law in Louisiana recognizing that unusual circumstances can make operations uneconomic, and this jurisprudence could possibly be used to justify utilizing the shut-in clause when the market is uneconomic, i.e., the lack of a viable market.

G. Lessor's Agreement or In-Kind Deliveries to Lessor

If practical, it would be wise before making any shut-in decision to approach your lessors and ask for their agreement that wells be shut-in, at least temporarily, while prices rebound to economic levels. 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 would 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.

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Many leases provide that the lessor can take its share of oil "in kind". If the lessor objects to shutting in the wells, one option may be to deliver their share "in kind" and the lessee keep its share in the ground.

H. Future Clause to Include "Uneconomic Markets"

Trying times and challenging issues often give rise to new provisions in contracts. As mentioned above, a typical shut-in clause today requires that there be a "lack of market or marketing facilities." We could argue that if storage is not available for produced oil, then there is in fact a lack of "facilities" thereby triggering the shut-in clause. The problem is that most leases limit shut-in clauses to "gas" facilities and storage facilities for oil don't qualify. The events that trigger the shut-in clause should be revisited and revised to include oil, a lack of economic markets and a lack of storage facilities for produced oil, in addition to the provisions covering gas.

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Now that we have seen how events can bring about uneconomic conditions and no viable storage options, I propose a re-draft to cover oil (not just gas) and also uneconomic markets (not just a "lack" of market)

no viable storage for oil, I propose a re-draft to cover oil (not just gas) and also uneconomic markets (not just a "lack" of market), which would include the following type wording:

> "If Lessee during or after the primary term should drill one or more wells on the leased premises, or acreage pooled therewith, capable of producing, in paying quantities, ***oil,*** gas or other hydrocarbons subject to this lease, including but not limited to ***condensate***, casinghead gas or similar substances associated with the production of oil or gas, and should Lessee be unable to produce the well(s) *because of lack of market* ***(including but not limited to an uneconomic market caused by unusual or abnormal circumstances), lack of storage*** *or marketing facilities,* or governmental restrictions, then Lessee's rights may be maintained beyond or after the primary term without production of minerals or further drilling operations, by paying Lessor, as a royalty, a sum equal to one dollar ($1.00) per acre of land covered hereby per year, the first payment being due, if said well should be completed or shut-in after the primary term, within the later of ninety (90) days after the completion of such well or ninety (90) days after the cessation of production, and such payment will extend Lessee's rights for one (1) year from the date of such completion or cessation...."

The clause should also contain other provisions, including payments after year one, instructions on whether payments are made by mail, etc.

I. Other Issues to Consider

Understanding your mineral leases is just the starting point when considering shutting-in or curtailing production. Other issues ... must be considered....

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

- Drilling and production obligations under any applicable joint operating agreement, "farmout", development agreement,
- 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 shut-in or curtail some volume of production. A comprehensive assessment and understanding is needed of the terms of each applicable lease, related contract, financing agreements, price hedges and regulatory requirements.

Contact Mr. Loewen at:

(985) 292-2000 (office)
(337) 280-6873 (cell)
or
rloewen@millinglaw.com

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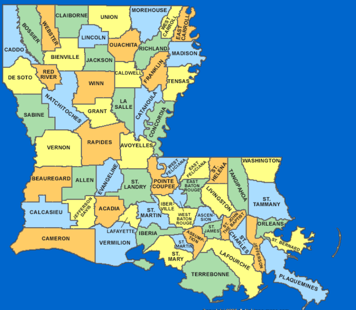

Next Issue:

In the next issue we will consider the application of continuous drilling clauses (such as a 90 day clock) and force majeure issues during these trying economic times.

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.

Final thought for the day:

How strange is it that Cinco de Mayo will fall on Taco Tuesday, and the whole thing will be cancelled by a virus named after a Mexican beer!

C. Randall Loewen
Attorney
(337) 280-6873 *(cell)*