

EMERGING TRENDS IN OIL AND GAS LAW

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for

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I. INTRODUCTION

- A. This material addresses what I believe are identifiable trends in oil and gas law. These issues should consume a major portion of your oil and gas practice in the coming years. I refer to these matters as "trends" because they appear to represent a break with the past - whether it be past drafting techniques, past practices, past application of common law concepts, or past judicial recognition of rights under traditional legal relationships.
- B. Although there may be some overlap among categories, I find, for discussion purposes, the major trends can be placed into four categories:
 - 1. Judicial willingness to break with the common law and legislative willingness to respond to oil and gas issues.
 - 2. The royalty owner as an operating "partner."
 - 3. Public utility law as a local component of traditional oil and gas practice.
 - 4. Development of new market-responsive contract terms and relationships.

II. THE "NEW" COMMON LAW OF OIL AND GAS

- A. For years commentators have questioned the wisdom of attempting to force emerging oil and gas property concepts into the existing mold of traditional property law. Instead, commentators have suggested

that "special" rules be developed and applied to this special type of property. However, this generally has not been done. Instead, courts have searched existing law for analogies in order to apply traditional property law to oil and gas.

For example, property in oil and gas is still largely determined by a rule of capture derived from analogies to wild animals and early English water law.

- B. The major area where courts have begun veering away from the common law is in the area of surface damages. The legislatures have generally rushed in to fill the void which the courts have identified.

For example, the traditional approach to surface use has been to find an implied easement to use the surface to the extent reasonably necessary to develop the conveyed minerals. Drawing from the common law analogy of the easement by necessity, the easement has generally been regarded as a "free easement." Therefore, the owner of the easement can exercise their easement rights without compensation for damages to the burdened "servient" estate.

- C. I predict the major new (surprising) developments in the property aspects of oil and gas will be the recognition of "new" rights through non-traditional property or contract analysis.

III. ROYALTY OWNER AS AN OPERATING "PARTNER"

A. The Royalty Owner

- 1. Royalty owners have a significant investment to oversee.
- 2. Most royalty owners fail to actively manage their oil and gas assets.

B. Developer/Lessee View Of The Royalty Owner

- 1. Passive nonparticipant.
- 2. Does not share in the risk of development.
- 3. Not necessary to consult royalty owner when making basic lease management decisions.

C. Relationship Created By Oil And Gas Lease

1. Developer and mineral owner obligated to act "honestly and fairly" toward each other.
2. Developer must act as a reasonable person would act when promoting the interests of the developer and the mineral owner.
3. Developer cannot trade or sacrifice mineral owner's interests to better developer's position.

D. As landowner's become more sophisticated, and the operational climate becomes more complex, the lessee/developer will be forced to deal with their lessor/landowner in the same manner they would deal with a working interest cotenant.

Unilateral decisions made by the lessee, which may affect the interests of their lessor, are made at the lessee's peril.

Counseling will include determining when it is mandatory or advisable to consult the lessor/landowner and what each party's rights are when they fail to agree on a course of action.

E. Future leasing documents should attempt to minimize the instances in which the lessor must be consulted and provide for a decision-making process; including a statement of each party's rights when they are unable to agree.

F. Two cases to guide future lessee conduct:

Amoco Production Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex. Civ. App. 1979), writ ref'd n.r.e., 611 S.W.2d 610 (1980).

Amoco Production Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981).

G. Developers Never Learn

1. Still use lease forms which perpetuate royalty calculation problems.
2. Attitude toward mineral owner has not changed - but it will after a few major judgments.

IV. PUBLIC UTILITY LAW AND THE OIL AND GAS PRACTITIONER

- A. "Deregulation" of natural gas and "open access" to pipelines, at the federal and state levels, will require the oil and gas practitioner to become versed in a body of federal and state regulatory law which traditionally has been limited to those representing the "regulated industries."

Instead of negotiating gas purchase agreements, the producer may be negotiating direct gas sales to a local distribution company (subject to state public utility regulation), negotiating transportation on intrastate and interstate pipelines (subject to state and federal public utility regulation), or attacking the "just and reasonableness" of a transportation rate or raising claims of "undue discrimination" being practiced by a regulated industry.

- B. Basic oil and gas decisions cannot be made without knowledge of FERC rules and regulations and similar law promulgated at the state level.

A "decision not to make any decisions" requires knowledge of FERC initiatives affecting the gas industry. For example, Order 451 creates options for gas producers. Failure to react properly to the availability of options may create liability to lessors under the implied covenant to market of the oil and gas lease.

V. MARKET-RESPONSIVE CONTRACTS

- A. Even before the "take or pay wars"* have been concluded, gas purchasers, predictably (because of the relatively low present price for gas and their enhanced bargaining position), are demanding long-term gas sale commitments from producers.

*I must recognize J. Michael Medina of the Oklahoma Bar for coining the appropriately descriptive phrase "Take or Pay Wars." See Medina, A Report from the Battle Zone: The Take of Pay Wars," 58 Okla. B. J. 2554 (Sept. 30 1987).

However, the basic flaws of previous contracts are being addressed through detailed market-responsive price and delivery terms.

Most participants in the industry now confess their inability to accurately predict events in what has

proven to be a volatile energy future. Two options:

1. Short-term contracts.
 2. Long-term contracts which are firm in commitment but flexible as to price, volume, and other essential market-sensitive terms.
- B. I would like to focus my comments today on one of the potentially longest term long-term contracts: the oil and gas lease. Specifically - the habendum clause.
1. Lessees seldom provide any sort of market-responsive terms in their leases.
 2. The result has been the premature abandonment of thousands of wells, waste of the oil and gas resource, and years of litigation to determine the continuing validity of oil and gas leases.

VI. HABENDUM CLAUSE - TRADITIONAL DRAFTING APPROACHES AND SOME NON-TRADITIONAL SUGGESTED APPROACHES

A. Primary Term.

1. Specify a term of years. "This Lease shall remain in force for a primary term of _____ years."
2. Problem - how do we calculate time? See Winn v. Nilsen, 670 P.2d 588 (Okla. 1983).
3. Time critical since the primary term is a special limitation on the grant.
4. Alternative Drafting Suggestions:
 - a. Primary term - specify date and time the lease terminates. LEASE - SECTION 2.A.
 - b. Secondary Term - indicate how the lease can be extended beyond the primary term. Refer to pertinent extension clauses; don't try to restate them in the habendum clause. LEASE - SECTION 2.B.

SUGGESTED RESPONSE: HABENDUM CLAUSE

SECTION 2. DURATION OF GRANT

A. TERMINATION DATE.

Unless extended by Subsection b., this Lease terminates at 5:00 PM 1 March 1990 (called the "Termination Date").

B. EXTENSION OF LEASE.

This Lease can be extended beyond the Termination Date pursuant to the terms of Sections 4, 5, 6, 7, 8, and 9.

B. Operations Clause.

1. In most states (except Oklahoma) must have actual production at the end of the primary term. To provide lessee with additional time to obtain production, a "completion" clause is used similar to the following:

"[I]f the Lessee shall commence operations for drilling at any time while this Lease is in force, this Lease shall remain in force and its terms shall continue so long as such operations are prosecuted and, if production results therefrom, then as long as production continues."

2. Major problem - what action constitutes "commence operations for drilling?" Must take the appropriate action and continue it diligently. NOTE: similar problem under the Drilling/Delay Rental Clause.
3. Kansas - undecided what will satisfy the commencement requirement. Anything less than actual drilling is risky.
 - a. Herl v. Legleiter, 9 Kan.App.2d 15, 668 P.2d 200 (1983) (interpreting similar language under drilling/delay rental clause).
 - b. A & M Oil, Inc. v. Miller, 11 Kan.App.2d 152 (1986) (interpreting clause similar to the commencement clause).

- c. Phillips v. Berg, 120 Kan. 446, 243 P. 1054 (1926) (hauling sand and cement to land and commencing to drill a water well, which water would presumably be used in drilling the oil well, was not "commencement of operations").
 - d. It appears where something less than actual drilling is being relied upon, the lessee should be able to demonstrate what amounts to an irrevocable commitment to conduct operations, to completion, on the leased land.
 - e. Good faith of lessee no defense - "[L]essee . . . may in good faith have attempted to commence a well, but as a matter of fact the steps he took fell short of accomplishing what he was attempting to do." Herl, 9 Kan.App.2d at 18, 668 P.2d at 203.
4. Oklahoma - Actual drilling not required. In Wilds v. Universal Resources Corp., 662 P.2d 303 (Okla. 1983), the court states:
- "[A] commencement clause of an oil and gas lease has been generally interpreted to mean that operations for the drilling of a well and not the actual drilling must be commenced prior to the end of the primary term with good faith intention of completing the operation."
- "The commencement provision in the lease at issue did not expressly require due diligence to avoid termination of the lease, but Oklahoma law has considered the requirement implicit."
5. Alternative Drafting Suggestions:
- a. A few simple definitions will save a lot of time and money.
 - b. Define exactly what the lessee must do to extend the lease. LEASE - SECTION 5.A.

C. Dry Hole Clause.

- 1. What happens if a well, drilled under an operations clause, is unable to produce in paying quantities? The lease will terminate unless there is a special clause addressing this problem.
- 2. Dry hole clause designed to address this problem

by permitting lessee to commence operations to drill other wells to try and obtain production in paying quantities.

Generally give lessee a stated period of time following "completion of a dry hole" to commence drilling operations on a new well.

3. Common problems - Commencement issue similar to the drilling/delay rental clause and operations clause. What is a dry hole? What about multiple dry holes? What is the effect of a dry hole during the primary term? (usually this problem is specifically addressed in existing lease forms).
4. Alternative Drafting Suggestions:
 - a. Define dry hole. LEASE - SECTION 5.B.
 - b. When is a dry hole completed? LEASE - SECTION 5.C.
 - c. What is the effect of a dry hole? LEASE - SECTION 5.
 - d. Coordinate with Cessation Clause since many times permanent cessation has the same effect as a dry hole.

SUGGESTED RESPONSE: OPERATIONS CLAUSE & DRY HOLE CLAUSE

SECTION 5. OPERATIONS

If, on the Termination Date, Operations are being conducted on the Leased Land, this Lease will extend beyond the Termination Date for so long as Operations are being diligently pursued. If Production results from the Operations, this Lease will remain in effect for so long as there is Production in Commercial Quantities as defined by Section 4.

If Operations result in a Dry Hole, LESSEE will have ninety (90) days following the date the Dry Hole is Completed to begin Operations on a new well. There is no limit on the number of Dry Holes LESSEE can drill under this Section.

A. "Operations" means:

Any action taken toward obtaining or regaining Production. This includes actual drilling and any act preparatory to

drilling, such as obtaining permits, contracting for drilling services, building roads, clearing a drill site, and hauling equipment and supplies.

B. "Dry Hole" means:

A well not capable of Production in Commercial Quantities.

C. "Completed" means:

The date the drilling rig is removed from the well site.

D. Production In Paying Quantities

1. Production must be sufficient to pay lessee a profit.
2. Traditional approach - lease in effect for primary term and "as long thereafter as oil, gas or other hydrocarbons is or can be produced."
 - a. Courts uniformly interpret "produced" to mean produced in paying quantities.
 - b. Common alternative approach - continue for so long as there is production, of any kind, whether in paying or nonpaying quantities.
3. No guidance on how to calculate "paying quantities." How much production is credited to lessee? What expenses are charged against such production? What accounting period is used to compare production and expenses?
4. How is enhanced recovery dealt with? May have substantial initial expenditures and a long period of time before success can be determined and investment evaluated.
5. Alternative Drafting Suggestions:
 - a. Could eliminate the paying quantities requirement altogether and merely require production sufficient to generate a stated amount of royalty each year.
 - b. If life of lease tied to production in paying quantities, you must expand the traditional

clause. LEASE - SECTION 4

c. Many key matters to resolve and define:

- (1) How do the parties wish to determine paying production? LEASE - SECTION 4.B.
- (2) How will income be allocated to lessee? LEASE - SECTION 4.C., D., & E.
- (3) What expenses will be deducted from income? LEASE - SECTION 4.F.
- (4) What period of time will be used to compare income and expenses? LEASE - SECTION 4.G.

SUGGESTED RESPONSE: PAYING QUANTITIES REQUIREMENT

SECTION 4. PRODUCTION

The duration of this Lease will extend beyond the Termination Date for so long as there is Production of one or more of the Leased Substances, in Commercial Quantities, from the Leased Land.

A. "Production" means:

The actual extraction of one or more of the Leased Substances from the Leased Land.

B. "Commercial Quantities" means:

The Value of Leased Substances extracted from the Leased Land exceeds Current Operating Costs during an appropriate Accounting Period.

C. "Value" is determined by multiplying the Production attributed to LESSEE times the Price of such Production.

D. Production attributed to LESSEE.

LESSEE will be deemed to receive 7/8ths of all Production, regardless of what LESSEE's actual share of Production may be after deducting royalty, nonoperating interests, and any other interests payable out of the leasehold interest.

E. Price of Production.

Production sold during the Accounting Period will be deemed to have been sold for an amount calculated by taking the average price paid for extracted Leased Substances during the Accounting Period, adding to such average price the highest price ever paid for extracted Leased Substances during the existence of the Lease, and then dividing the total by two.

F. "Current Operating Costs" include only amounts actually paid by LESSEE which relate directly to the operation of a well or wells on the Leased Land. The following costs are representative of items which will be included as Current Operating Costs:

1. Energy purchased to operate equipment used to produce Leased Substances.

2. Taxes relating to the Lease or production from the Leased Land.

3. Material and labor necessary for the routine maintenance of wells.

4. Material and labor necessary for the routine maintenance of roads and other structures on the Leased Land used to support production.

[5. Transportation of production.]

The following costs are representative of items which will not be included as Current Operating Costs:

1. Drilling, completing, and equipping wells.

2. Replacing major items associated with the continued operation of the Lease. This includes such things as replacing pumping units, tubing, casing, wellhead apparatus, separators, heater-treaters, injection wells, and storage tanks.

3. Stimulating wells, to include fracturing, acidizing, and similar techniques.

4. Reworking operations designed to regain or improve production from a well.

5. Planning for Enhanced Recovery operations and the cost of any pilot project to determine whether Enhanced Recovery techniques are feasible.

6. Overhead, depreciation, and income taxes.

7. Plugging wells and reclaiming affected surface areas.

8. Pipelines necessary to deliver Production to a purchaser.

G. "Accounting Period" means:

A period of time which adequately reflects the productive potential of the Leased Land. The Accounting Period should be long enough to provide LESSEE with sufficient information to determine whether to continue operating the Leased Land. If LESSEE is conducting Enhanced Recovery operations on the Leased Land, the Accounting Period should be long enough to evaluate the success of such operations.

[Alternatives - select a period of time such as 12 months or 18 months to determine production issue.]

E. Cessation of Production.

1. What happens if there is production in paying quantities when the primary term ends but the well subsequently ceases to produce in paying quantities?

a. Cessation permanent, lease terminates - absent a special lease provision covering this problem.

b. Cessation temporary - have a reasonable time to regain production in paying quantities.

2. Traditional approach - expand rights when cessation permanent and restrict rights when cessation temporary. For example:

"If, after the expiration of the primary term of this Lease, production on the leased premises shall cease from any cause, this Lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues."

3. Major problems: What action is required to resume "operations for drilling a well?" When did the event triggering the clause occur?
4. Alternative Drafting Suggestions:
 - a. Retain temporary cessation flexibility. Kelwood Farms, Inc. v. Ritchie, 1 Kan.App.2d 472, 571 P.2d 338 (1977) (seventeen-month cessation of production held to be temporary). LEASE - SECTION 6.A.
 - b. Definition of production makes it easier to determine when cessation occurs. LEASE - SECTION 6.B. Hoyt v. Continental Oil Co., 606 P.2d 560 (Okla. 1980) (cessation clause requires lessee to commence drilling or reworking operations within 60 days from date well ceased to produce in paying quantities).

SUGGESTED RESPONSE: CESSATION OF PRODUCTION CLAUSE

SECTION 6. CESSATION OF PRODUCTION

A. TEMPORARY CESSATION.

LESSOR and LESSEE recognize that Production will be interrupted periodically for well maintenance, reworking, and other activities. Such temporary cessations of Production will not terminate the Lease so long as LESSEE takes action within a reasonable time to restore Production.

B. PERMANENT CESSATION.

If Production ceases, due to an exhaustion of recoverable Leased Substances from existing wells, LESSEE has ninety (90) days following the date of such cessation to begin Operations in an effort to regain Production in Commercial Quantities from the Leased Land.

F. Shut-In Royalty Clause.

1. What happens if a well is drilled, it is not a dry hole, it is capable of producing, but lessee is unable to produce the well because there is no

market for production? Lease terminates in most states (except Oklahoma) unless there is production. Shut-in Royalty Clause designed to substitute a periodic cash payment for actual production.

2. Traditional Approach - Limit scope of clause to gas. Make payment of shut-in royalty the event which maintains the lease in effect.

a. "[I]f there is a gas well . . . on the . . . land . . . and such well or wells are shut in before or after production therefrom, lessee . . . may pay . . . at the end of each yearly period during which such gas well or gas wells are shut in, as substitute gas royalty, a sum equal to the amount of delay rentals . . . and if such payments or tenders are made it shall be considered under all provisions of this lease that gas is being produced"

b. "Where there is a gas well, or wells on the lands covered by this Lease . . . and such well or wells are shut-in, and there is no other production [or other clause] keeping this Lease in force . . . , Lessee shall pay as royalty to Lessor . . . the sum of \$1.00 per year per net royalty acre . . . and upon such payment it shall be considered that this Lease is maintained in full force and effect."

3. Major Problems:

a. Often special limitation language is used in shut-in royalty clauses. This seems odd since a lessee will seldom want to surrender a well, or wells, capable of producing in paying quantities. See, e.g., Amber Oil & Gas Co. v. Bratton, 711 S.W.2d 741 (Tex. Ct. App. 1986) (lessee accidentally paid shut-in royalty to wrong party - lease terminated). But see Gard v. Kaiser, 582 P.2d 1311 (Okla. 1978) (failure to comply strictly with shut-in clause will not result in automatic termination of the lease).

b. When can lessee declare a well shut in and for what purposes?

c. Clause limited to gas.

- d. Should there be a limit on how long it can be shut in?

4. Alternative Drafting Suggestions:

- a. Avoid special limitation language. LEASE - SECTION 7.
- b. Identify events authorizing shut-in status. LEASE - SECTION 7.A. - C.
- c. Provide a procedure for putting the clause in effect. LEASE - SECTION 7.

SUGGESTED RESPONSE: SHUT-IN ROYALTY CLAUSE

SECTION 7. UNABLE TO MARKET PRODUCTION

If the Leased Land is capable of Production in Commercial Quantities, but LESSEE is unable to market Production because of the inability to Access a Market, Unacceptable Terms, or Market Conditions, LESSEE may Declare wells on the Leased Land to be Shut-in.

The duration of this Lease will extend beyond the Termination Date for so long as a Shut-in well exists on the Leased Land.

If LESSEE is relying upon this Section to extend the Lease beyond the Termination Date, and Production is Shut-in for ninety (90) consecutive days following the date the well was Declared Shut-in, LESSEE will pay to LESSOR \$500.00 as an Advanced Royalty. If Production remains Shut-in, LESSEE will pay LESSOR \$500.00 for each period of 365 consecutive days following the initial ninety (90) day period. LESSEE will pay any Advanced Royalty due under this Section within a reasonable time following the close of the Shut-in period entitling LESSOR to Advanced Royalty.

- a. "Access to Market" means:

The availability of a mode of transportation, under reasonable terms, to deliver Leased Substances to a buyer.

- b. "Unacceptable Terms" means:

Offered contract terms which are not reasonable when compared with terms of existing contracts with other producers similarly situated to LESSEE. If comparison is not possible,

then any term which a reasonable person in LESSEE's position would find unconscionable. The terms may relate to an offer to buy, transport, treat, or market Leased Substances.

c. "Market Conditions" means:

The market price being paid for a Leased Substance is such that a reasonable person in LESSEE's position, having the power to do so, would refrain from marketing the Leased Substance.

d. "Declare" and "Declared" means:

LESSEE objectively manifests to LESSOR that Production from the Leased Land is Shut-in.

e. "Shut-in" means:

A well capable of Production which is not being produced.

f. "Advanced Royalty" means:

A payment made under this Section which LESSEE can recoup from future royalty payable to LESSOR. LESSEE can recoup Advanced Royalty only to the extent there is future royalty payable to LESSOR.

G. Force Majeure

1. What happens if it rains for two weeks prior to the end of the primary term and lessee is unable to access the land to conduct operations? What happens if the state corporation commission, or the federal government, prohibits drilling on the leased land for two weeks prior to the end of the primary term? What if employees, equipment, or materials are not available? Absent a special lease clause, the lease will terminate.
2. Typically, development of the lease is within lessee's control.
3. Development situations beyond lessee's control, but typically addressed by a lease clause:
 - a. Results of development - no control so provide for possibility of dry hole or cessation with the appropriate lease clause.

- b. Market for production - no control so provide for possibility of well being shut-in awaiting a market.
- 4. Development situations beyond lessee's control, but often not addressed by a lease clause:
 - a. Poor weather, natural disaster, disease. Acts of God.
 - b. War, control of raw materials, markets, and lessee's activities. Acts of Government.
- 5. Regardless of the equities involved, courts will not expand the lease contract to account for unforeseen and uncontrollable occurrences which prevent the lessee from complying with the express terms of the lease. Baldwin v. Oil Co., 106 Kan. 848, 850, 189 P. 920, 921 (1920) (lessee unable to complete well within primary term because of intervening drought followed by excessive rain and a blizzard; lessee's employees became diseased; federal government, reacting to wartime needs, prohibited the use of coal or iron in drilling wells on the leased land - HELD: no excuse because the obligation undertaken was absolute).
- 6. Major Problems: Scope of events subject to force majeure. Effect of force majeure on lease provisions. How to calculate the duration of force majeure.
- 7. Alternative Drafting Suggestions:
 - a. Identify events giving rise to force majeure. LEASE - SECTION 8.A.
 - b. Identify procedure for initiating force majeure and calculating its effect on lease time periods. LEASE - SECTION 8.

SUGGESTED RESPONSE: FORCE MAJEURE CLAUSE

SECTION 8. UNAVOIDABLE CIRCUMSTANCES

Calculation of time under this Lease, including the Termination Date and any extensions of the Termination Date, can be affected by any period of time when LESSEE is unable to exercise his Lease rights due to Unavoidable Circumstances.

When any event occurs, constituting Unavoidable Circumstances, LESSEE can provide LESSOR with a Suspension Notice. Lease Suspension begins on the date LESSOR receives the Suspension Notice and terminates on the date LESSEE is able to resume exercise of its Lease rights. When a Lease Suspension terminates LESSEE will provide LESSOR with a Resumption Notice.

Any Suspension Period will be added to the Lease and will extend the Lease terms, to include the Termination Date and any extensions of the Termination Date. To claim any Suspension Period, LESSEE must comply with the terms of this SECTION.

The total amount of time that a Lease can be extended by this Section, including all Suspension Periods, cannot exceed 730 days.

If the event giving rise to Unavoidable Circumstances is caused by a wrongful or negligent act of LESSEE, this SECTION will not apply.

A. "Unavoidable Circumstances" means:

Acts of God, including weather and conditions caused by weather, adverse conditions at or near the Leased Land caused by LESSOR or third parties, LESSOR's unauthorized obstruction of LESSEE's activities, laws, orders, or requests by federal, state, and local governments or their employees, unavailability of equipment, material, labor, or support services, or any other act, beyond LESSEE's control, which prevents LESSEE from exercising his Lease rights. If title to the Leased Land or one or more Leased Substances is being disputed, and it would be imprudent for LESSEE to exercise Lease rights until the dispute is determined, court proceedings to determine title constitute Unavoidable Circumstances.

However, it is not Unavoidable Circumstances when LESSEE is unable to exercise Lease rights because of LESSEE's financial condition.

B. "Suspension Notice" means:

LESSEE's written notice to LESSOR describing the Unavoidable Circumstances preventing LESSEE from exercising his Lease rights.

C. "Lease Suspension" means:

The Lease, for all purposes, is suspended. The time for computing any rights or obligations under the Lease are suspended.

D. "Resumption Notice" means:

LESSEE's written notice to LESSOR indicating the specific date Unavoidable Circumstances terminated and LESSEE was able to resume exercising Lease rights.

E. "Suspension Period" means:

The period of time from the date the Suspension Notice was received by LESSOR to the date, indicated in the Resumption Notice, when the events constituting Unavoidable Circumstances terminated. The day the Suspension Notice was received, and the day stated in the Resumption Notice, will each be counted as a day when calculating the total duration of the Suspension Period.

H. A Lessor's Perspective

1. Although the suggested lease provisions are drafted to maximize the lessee's interests under the lease, each clause can be altered to favor the lessor.
2. The same issues should be addressed whether representing the lessee or lessor. This will avoid potential disputes. My basic premise in these matters is: It is better to fight the battles at the negotiation stage, declare the "winner," and record the victory clearly in the lease document. Hopefully this will avoid fighting unnecessary battles at the post-lease stage where it requires judicial intervention to determine and marshal each party's rights.
3. Note how the same issues adversely affect the lessor. For example, what is required to "commence" a well to satisfy the Drilling/Delay Rental Clause or the Commencement Clause? The lessor must deal with the same uncertainty created by terms such as "commence."

To clarify the rights of the parties, while giving the lessor maximum protection, the lease could define commence as "actual penetration of the earth with a drill bit operated by a drilling rig capable of drilling to the target formation identified in lessee's drilling permit [notice of intent to drill]."

This would provide the lessor with an objective standard which could be readily policed. If a rig was not on the site drilling on the critical date, the lease terminates.

I. To demonstrate how the lease drafting process can be used to maximize the landowner's position, consider the following royalty matters:

J. Royalty Clause - Current Practices.

1. Most lease forms utilize the traditional cryptic code to determine the gross and net value of lessor's royalty. For example:

"The royalties to be paid lessee are:

"(a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected;

"(b) on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale;"

K. Royalty Clause - Major Problems.

1. What costs can be deducted from lessor's royalty?

a. Most clauses presume the lessor will take oil royalty in kind. In practice oil royalty is sold by lessee with lessee's share of production.

b. Variation of oil royalty clause:

"Lessee shall deliver to Lessor as royalty, free of cost, on the Lease, or into the pipeline to which the Lessee may connect its well, the equal one-eighth part of all oil produced and saved from the leased premises, or at the Lessee's option, may pay to the Lessor for such one-eighth royalty the market price for oil of like grade and gravity

prevailing on the day such oil is run into the pipeline or into storage tanks."

- c. If lessee is required to treat the oil to remove water, and then transport it by truck to a refinery, can any of these costs be charged against lessor's share of production? If so, how will such expenses be calculated?
 - d. Marketing gas may require treatment, gathering, and compression. Can lessee charge any part of these costs against lessor's share of production? If so, how will such expenses be calculated?
- 2. How will the "value" of production be determined? What is market value?
 - 3. What are "proceeds?" Is it anything a lessee receives in consideration for the transfer of title to the gas?
 - 4. To what extent can lessor participate in any of lessee's other business activities? Separate liquid hydrocarbons from a gas stream and sell liquids and residue gas for an amount ten times greater than the value assigned to the unprocessed gas for royalty purposes.
 - 5. What are the mechanics of payment?

L. Royalty Clause - Alternative Drafting Suggestions
Matters the Clause Should Address:

- 1. How the gross value of royalty will be determined.
- 2. Costs lessee can deduct from the gross value to arrive at lessor's royalty.

M. Calculating Gross And Net Value:

- 1. At what point in the production process will gross value be determined?
 - a. At the well?
 - b. First sale?
 - c. What's the effect of lessee using the production? What's the effect of a sale to

lessee or its affiliate?

- d. What if the gas is processed to separate it into its liquid and gas components for sale?
 - e. What if other components of the production stream are removed in treating or processing the gas?
 - f. What if the production is not sold, but instead "exchanged" for other production?
2. What expenses can lessee deduct (charge against lessor's share of production) to arrive at the net value of production to calculate royalty?
- a. A stated formula or actual costs? Lessee better off using a stated formula.
 - b. If lessor receives royalty on processed gas, must lessor pay a share of processing costs?
 - c. Will lessor be responsible for its share of treating, compression, transportation, and other marketing costs?
 - d. What is the effect of lessee reserving certain rights under a gas purchase agreement?
3. Proceeds Lease.
- a. Define proceeds to include or exclude other gas contract benefits.

Consider Amoco Production Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex. Civ. App. 1979), writ refused n.r.e. (lessee traded for benefits under gas contract which affected lessor's royalty).
 - b. Address lessee's rights to amend or otherwise manage the gas contract.
4. Market Value Lease.
- a. Define market value and how it will be determined.
 - b. If a Waechter lease, remember the structure of the gas sales agreement will affect how royalty is determined.

N. General Advice To Lessees - Be sensitive to situations where it is necessary, or advisable, to include lessor in the lease operation decision-making process.

1. A concept foreign to lessees.
2. Kansas Supreme Court has often noted the lessee's failure to consult the lessor on matters directly affecting lessor's economic interest. See, e.g., Schupbach v. Continental Oil Co., 193 Kan. 401, 406, 394 P.2d 1, 5 (1964).
3. What do you think a lessor would have done in 1965 if the lessee had gone to them and said: "We have a gas purchaser willing to enter into a gas purchase agreement to buy all the gas from our well for the next 20 years - under these terms"

If the price and other contract terms were reasonable, at that time, do you think the lessor would have been willing to amend the lease to accept the gas contract proceeds for calculating royalty?

O. Share Of Production.

1. State the proportionate share of production excepted from the grant and retained by the lessor.
2. Use fraction or percentage. Make it clear you are excepting a share of all production.
 - a. 1/8 of 8/8 of production.
 - b. 12.5% of 100% of production.
 - c. 12.5% of all production. LEASE - SECTION 10.A.1.
3. Nothing sacred about a 1/8th royalty. Bargaining position and prowess will determine the lessor's share of production.

P. Processed Production.

1. Indicate whether lessor will have any claim to a royalty based upon the value of products separated from production. LEASE - SECTION 10.A.2. and 10.G.3.

2. If lessor's royalty includes processed production, are any costs chargeable against lessor as a result of such processing? How will they be calculated? LEASE - SECTION 10.B.1.

Q. Gross Value Of Production.

1. Indicate how production will be valued. LEASE - SECTION 10.D.
2. What if lessee sells a leased substance under a long-term sales contract? LEASE - SECTION 10.D.3.

R. Net Value Of Production.

1. What costs are deductible from lessor's share of production? LEASE - SECTION 10.B.1. and 10.B.2.
2. How will such costs be determined? Formula or actual costs? Formula is more manageable.

S. Payment Details.

1. When is initial payment due after a well begins to produce? When are payments due on subsequent production? LEASE - SECTION 10.E.
2. Must lessor sign a division order? LEASE - SECTION 10.F.
3. What periodic documents must lessee provide to lessor? LEASE - SECTION 10.E.

SUGGESTED RESPONSE: ROYALTY CLAUSE

SECTION 10. ROYALTY

LESSEE will pay to LESSOR a Royalty as follows:

A. LESSOR'S SHARE OF PRODUCTION.

1. LEASED SUBSTANCES.

There is excepted from this Lease and retained by LESSOR, out of Production from or attributable to the Leased Land, 12.5% of all Leased Substances Produced And Saved. [NOTE: may want separate royalty provisions for helium, hydrogen, nitrogen, and carbon dioxide.]

2. PRODUCTS FROM LEASED SUBSTANCES.

If LESSEE, or any affiliate of LESSEE, Processes a Leased Substance, LESSOR is entitled to 12.5% of the Leased Substance after Processing. LESSOR has the continuing option to either receive a Royalty on a Leased Substance before or after Processing. LESSOR elects, at this time, to receive Royalty on Leased Substances after Processing.

B. COSTS.

1. DEVELOPMENT, PRODUCTION, PROCESSING, AND MARKETING COSTS.

LESSOR's Royalty is not burdened by any expenses or charges relating to developing, producing, operating, treating, gathering, compressing, transporting, processing, manufacturing, or marketing Leased Substances or Processed Leased Substances. Such expenses are payable solely from LESSEE's share of Production.

2. TAXES.

Properly assessed taxes, levied against LESSOR's Royalty, can be deducted from LESSOR's Royalty to reimburse LESSEE or any third party properly paying such taxes.

C. OPTION TO TAKE IN KIND.

LESSOR has the continuing option to take all or any part of Royalty in kind by giving LESSEE notice at least 30 days prior to the effective date of LESSOR's election. LESSOR will give LESSEE similar notice in advance of ceasing to take in kind. In the event LESSOR elects to take in kind, LESSOR can require LESSEE to deliver Royalty, without cost to LESSOR, to the pipelines, tanks, separators, or manufacturing plant tailgates which wells on the Leased Land may be connected.

D. VALUE OF PRODUCTION NOT TAKEN IN KIND.

To the extent LESSOR has not elected to take Royalty in kind, LESSEE will pay LESSOR an amount equal to the greater of:

1. GROSS PROCEEDS.

The gross proceeds from the sale of Leased Substances; or

2. MARKET VALUE.

The market value of Leased Substances. It is presumed that a current sale of Leased Substances, to a third party in an arms-length transaction, represents market value.

3. SALES CONTRACTS.

If LESSEE plans to commit its share of Production from the Leased Land to a sales contract, LESSEE will provide LESSOR with a copy of the proposed sales contract. LESSOR has the option, within 30 days following receipt of the sales contract, to elect to have Royalty calculated according to the terms of the sales contract. If LESSOR elects, in writing, to commit to the sales contract, LESSEE will calculate LESSOR's Royalty based upon the proceeds paid to LESSEE under the approved contract.

However, LESSOR's Royalty will be calculated as though any automatic price escalation clause, or other provisions having the potential to increase proceeds payable on production, (such as take-or-pay rights and severance tax reimbursements), became effective on the earliest date permitted under the contract. Royalty will be paid as though such amounts were paid to LESSEE, even though LESSEE fails to initiate the process to become entitled to the increased proceeds or fails to actually collect such increased proceeds.

E. PAYMENT.

LESSEE will pay LESSOR's Royalty no later than 90 days after Production is obtained from the Leased Land. After the first Royalty payment, subsequent payments will be made no later than 15 days following the month in which the Leased Substances were produced. Any amount not paid when due under this Subsection will bear interest at an annual percentage rate of 18%.

[Payment documentation - monthly accounting information.]

F. DIVISION ORDER

LESSOR agrees to sign division orders certifying LESSOR's ownership interest in Leased Substances and the Leased Land to prevent LESSOR, while the division order remains unrevoked, from claiming any greater ownership interest for purposes of the payment of Royalty. Any division order signed by LESSOR must be revokable at LESSOR's election.

G. DEFINITIONS.

1. "Royalty" means:

LESSOR's share of Production provided for by this SECTION.

2. "Produced And Saved" means:

The Leased Substance has been extracted from the Leased Land and is available for sale or use. Any intentionally flared or vented gas, or gas from a Unit delivered under a free gas

clause, is deemed to be Produced And Saved. Leased Substances unavoidably lost during prudent operations are not considered Produced And Saved. Subject to SECTION 1.G.2., Leased Substances used to support Lease or Unit operations are deemed to be Produced And Saved.

3. "Process," "Processed," and "Processing" mean:

A Leased Substance is separated into various products or otherwise treated or altered to enhance its value.

Sample Problem Demonstrating "Paying Quantities" Calculation

Big Oil Company leases the Northwest Quarter of Section 30 from Fred Farmer in 1979. Since the price of oil is at about \$34/barrel, Big Oil drills a well on Section 30. From 1979 through 1982 the well produces, on average, 35 barrels of oil each day. Production gradually declines; the well is currently producing 2 barrels each day. If the issue is litigated in 1986, the price of oil may be as low as \$9/barrel.

Under the traditional form of habendum clause, courts generally look at the current value of oil to determine whether the lease is producing in paying quantities. This is multiplied by the quantity of production to arrive at the base revenue figure.

If the issue arose while oil was selling for \$9/barrel, and production was 2 barrels each day, and assuming a 1/8th royalty under the lease, the daily income credited to the lessee will be \$15.75 ($[2 \times \$9] \times 7/8$).

Applying the formula in my alternative drafting response, SECTION 4. E., assume the accounting period is set at the most recent 18 month period. During that time oil sold for \$25, 20, 15, 11, and 9/barrel. The average price for oil sold during the accounting period would be \$16/barrel ($[25 + 20 + 15 + 11 + 9]$ divided by 5).

Add to the \$16 price the highest price ever paid for oil during the existence of the lease; in this case \$34/barrel. This gives us \$50 which is then divided by 2 to arrive at the "Price of Production" for calculating paying quantities under the habendum clause - \$25/barrel.

Therefore, daily lease income attributed to the lessee would be \$43.75 ($[2 \times \$25] \times 7/8$) instead of \$15.75.