How to determine whether to hold or terminate an oil and gas lease

When a landowner leases property to an energy company, the lease agreement typically contains a held-by-production provision, also known as a habendum clause. In Oklahoma, habendum clauses in oil and gas leases establish that after the primary lease term has ended, the lease shall remain in force as long as the land is capable of producing a minimum amount of oil or gas. But how do courts decide whether to hold or end such a lease?

Habendum clauses typically describe the lease term as, "from the date hereof and as long thereafter as oil or gas … is produced from said land." When the term "produced" is used in a "thereafter" provision of the habendum clause, it has been determined by courts to mean production in "paying quantities."

However, "paying quantities" is not determined by a specific dollar amount. Rather, it is defined as an amount of production sufficient to yield a profit to the lessee beyond lifting expenses, which include costs of operating the pumps, gross production taxes and electricity.

To determine whether a lease is commercially producing and, therefore, may be held by production, there are four factors that courts take into account: the accounting period, revenue during that period, expenses during that period, and equitable considerations.

The accounting period chosen for any production analysis varies and is determined by examining facts and circumstances specific to the lease. Accounting periods can make or break a case when trying to ascertain whether there was production in paying quantities. Thus, to reflect the production status, it is crucial to determine a sufficient amount of time that would provide information that would allow a "reasonable and prudent operator" to decide whether to continue or cease operation.

For example, in *Hoyt v. Continental Oil Co.*, the accounting period was 14 months. In *Smith v. Marshall Oil Corp.*, the accounting period was 35 months.

Once an accounting period is established, all revenue generated by the lease during that period is considered. Next, lifting expenses are considered and compared against revenue to see which is greater. However, this consideration does not include overriding royalties, overhead, and depreciation.

Lastly, if the lease is unprofitable, the court will examine any equitable considerations to determine if any justify maintaining the lease. These considerations are very specific to the circumstances of the lease that may affect profitability, which could include market conditions, changes in public policy, pipeline access, and conflict resolution activity.

If, after examining all factors, it is determined that the oil and gas lease is returning a profit over lifting expenses, the lease will not be vulnerable to termination and shall be allowed to continue beyond the primary lease term.

Originally published in The Journal Record on July 5, 2019.