OHIO COURT OF APPEALS AFFIRMS "PAYING QUANTITIES" RULING AGAINST LOCAL PRODUCER

David J. Wigham | *Attorney*

On July 3, 2018, Ohio's Seventh District Court of Appeals issued another significant decision clarifying Ohio law regarding "production paying quantities" that could impact the future of many "lack of production" cases in Ohio. In Kraynak v. Koy L. Whitaker, 2018-Ohio-2784, the Court of Appeals, among other things, clarified what operating expenses should be considered in calculating the profitability of an oil and gas well to determine if the well is producing in sufficient quantities to hold the oil and gas lease in its secondary term.

To understand the depth of this ruling, it is important to understand the concept of "paying quantities" and why it matters under an oil and gas lease. In Ohio, most oil and gas leases contain a primary term and a secondary term. The primary term is a period of years within which the producer must commence drilling operations in search of oil and gas. If, after the expiration of the primary term, the conditions of the secondary term are not being met, then the lease automatically expires by its own terms.

The secondary term of an oil and gas lease is indefinite and extends the producer's rights under the lease, typically "for so long as oil and gas are produced in paying quantities." In order to extend an oil and gas beyond its primary term, oil or gas must actually be discovered and produced in paying quantities. In other words, there must be actual production from a well, and that production must generate a profit over and above operating expenses attributed to the well or wells drilled under the lease.

An oil and gas lease that is in its secondary term automatically expires on the day the well stops producing in paying quantities. Once a lease expires, ownership of the mineral rights for all formations covered by the lease, typically including the Shale rights, reverts back to the landowner. This allows the landowner to lease its mineral rights, in certain situations, to a Shale producer for a lucrative bonus and a higher royalty; hence, the significance of whether a lease is being held by production from a well that is producing in "paying quantities."

The Ohio Supreme Court defined "paying quantities" in Blausey v. Stein as: "quantities of oil or gas sufficient to yield a profit, even small, to the lessee over operating expenses, even though the drilling costs, or equipping costs, are not recovered, and even though the undertaking as a whole may result in loss." More recent rulings by Ohio's Seventh Appellate District have further shaped this analysis. For example, whether a well is profitable is usually left to the good faith judgment of the producer, and the party asserting the claim that the well is not producing in paying quantities carried the burden of proof. Also, only direct operating costs, and not indirect costs that do not contribute to the production of oil and gas, will be considered in a paying quantities analysis. Moreover, a producer cannot report income under the Blausey test without first subtracting the landowner royalties paid to the lessor because royalty paid to the lessor from the well's production cannot qualify as "profit to the lessee over operating expenses." Finally, regarding the issue of operating expenses, a producer cannot stop allocating internal operating expenses for operating of the well because, by not charging internal operating expenses, the expenses of the well would be artificially deflated (and the profitability of the well would be artificially inflated).

In the Kraynak case, the landowner leased his 99-acre farm in Monroe County, Ohio to Whitaker Enterprises in

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2006. Whitaker operated the K. Kraynak No. 1 well on this property. Later, the Shale rights under this lease were assigned to Gulfport Energy.

Whitaker Enterprises also owned and operated Whitaker Store, which was the third-party operator responsible for servicing the well. Between 2012 and 2015, Whitaker Enterprises paid Whitaker Store $300 per month, or $3,600 per year, to operate the well. Between this period, when factoring in production income and operating expenses, the well was determined to be not profitable for each of these four years. Also, Whitaker could not reallocate the $300 monthly operating expenses as "indirect" expenses, because doing so would artificially make the well appear profitable. Accordingly, the Court of Appeals affirmed the trial court's ruling that the Whitaker lease had expired. As a result of this ruling, ownership of the minerals, including Gulfport's Shale rights, reverted to the landowner.

The Kraynak case is another important decision in the current legal battleground over the ownership of the valuable mineral rights in Ohio. This ruling elaborates on how Ohio law interprets "production in paying quantities." This case also illustrates how producers cannot internally alter operating costs attributable to a well in an effort to hold a lease that also covers the Shale rights. And, given the recent downturn in oil and gas prices, producers are facing ever increasing challenges to operate wells profitably in order to continue to control ownership of the valuable mineral rights. This opens the door for landowners to challenge lease validity. Landowners are encouraged to seek counsel from an experienced oil and gas attorney to help determine whether a case exists against a producer who is attempting to operate a well in "paying quantities" to hold a lease in its secondary term, and thereby deprive the mineral owner of lucrative lease bonuses and higher royalties.

David J. Wigham is a second-generation oil and gas attorney at the firm of Roetzel & Andress, with more than 25 years of experience in the industry. He maintains offices in Akron and Wooster, Ohio, and can be reached at 330-762-7969 or dwigham@ralaw.com.