Ohio Court of Appeals Clarifies “Production in Paying Quantities” Rule

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On June 16, 2017, Ohio’s Seventh District Court of Appeals issued an important “paying quantities” decision against Beck Energy that will surely shape the future of many “lack of production” cases in Ohio. In Paulus v. Beck Energy Corp. 2017-Ohio-5716, the Court of Appeals, among other things, clarified what income and expenses should be considered in calculating “production in paying quantities” under an oil and gas lease in its secondary term.

To understand the depth of this ruling, it is important to explain what “paying quantities” is 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 actually must be discovered and produced in paying quantities. In other words, there must be actual production that generates 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 by its own terms on the day the well stops producing in paying quantities. Once a lease expires, ownership of the mineral rights, including the shale rights, reverts back to the mineral owner. This allows the mineral owner 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 has already 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.”

The Paulus ruling elaborates on this test by providing guidance on what may be considered when determining paying quantities and lack of production in Ohio. First, the Court examined what items may be deducted from oil and gas income before determining profit. A producer cannot report income under the Blausey test without first subtracting the landowner royalties paid to the lessor. A royalty paid to the lessor from the well’s production cannot qualify as “profit to the lessee over operating expenses.”

Next was the issue of operating expenses. In the Paulus case, Beck Energy had stopped allocating internal operating expenses related to a salaried employee for operating of the well at issue. These operating costs were previously allocated in prior years. In other words, by not charging internal operating expenses it had charged in earlier years, the producer was artificially deflating operating costs to its benefit. When these internal expenses were added back in, there was no question the well in question was not producing in paying quantities sufficient to hold the lease in its secondary term.

Finally, the Paulus Court tackled the issue of market conditions and the good faith efforts by the producer to continue production in paying quantities in a depressed commodities market. The Court found that market conditions are irrelevant, and that “profitability, under the income minus operating expenses, is the standard in Ohio.” The fluctuation of market conditions may be used to consider a base period for the profitability calculation, but it is not a consideration that must be weighed when evaluating paying quantities and lack of production. Moreover, the producer’s good faith judgment does become a factor unless and until the well is profitable. Significantly, the Court declined to apply a good faith factor that would possibly allow a producer to continue a lease in perpetuity at the producer’s “sole and arbitrary discretion” based on speculation that the market may improve.

The Paulus 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 “production in paying quantities” is defined under Ohio law. This case also illustrates why a mineral owner cannot rely upon royalty statements from a producer to determine whether a lease is valid because the producer controls all of the information related to expenses. And given the recent downturn in commodity pricing, 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 mineral owners to challenge lease validity. Mineral owners 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.

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