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Chapter 25

Held By Production Leases: When Are They Actually Held?

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Synopsis

§ 25.01. Introduction.

The 21st century, in its relatively short span of 15 years, has seen remarkable change in the energy sector, and every resource from renewables to coal to oil and gas has been affected. Incredible discoveries and new technologies for the development and production of both oil and gas have resulted in the large scale displacement of coal for energy power generation, and, for the first time in our lifetimes, we have gained independence from reliance on foreign oil. Enhanced air quality regulations have influenced closure of coal-fired power plants so that in 2015, use of gas has exceeded coal in electric power generation for the first time. No one would have forecast any of this in the year 2000.

If we look back to the turn of the century, the Nymex price of gas was $2.36.[1] Indeed, this price was not much different than the average wellhead price of gas from 1985 to 2000, $2.01. This relatively long period of stable but low prices resulted in demand for natural gas catching up with supply and a stagnation in new drilling. Suggestion was made in some quarters that gas resources were being depleted. In the cyclical gas business, demand appeared to outpace supply, and gas prices spiked to $8.90 in December 2000. Prices settled back and reached a low of $2.19 in September 2001, but then averaged about $3 in 2002. Starting in 2003, however, average prices jumped to $7 and climbed to an all-time high of $13.42 in October 2005. The sustained high price levels from 2003 to 2010 were unprecedented in the history of

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1 All natural gas prices are taken from Energy Information Administration, Henry Hub Natural Gas Spot Prices (2015), available at http://www.eia.gov/dnav/ng/hist/rngwhhdm.htm.

the gas industry, and, at these prices, the gas business was good and a surge in drilling of new conventional wells occurred.

During this period, a small Texas company, Mitchell Energy, employed a "slickwater" hydraulic fracture technique in the Barnett Shale formation in Texas.[2] The "slickwater," likened to water and dish soap, was highly successful and provided the first glimpse of the forthcoming revolution in shale gas plays. Shortly after, in 2004, Range Resources used a similar hydraulic fracturing technique in its Renz Well in Washington County, Pennsylvania, and found similar success. Back in Texas, Devon Energy, with expertise in horizontal drilling, acquired Mitchell Energy and drilled horizontal wells into the Barnett shale with multi-stage hydraulic fracturing completions, again with high success. Following suit again, Range Resources began drilling horizontal wells in 2007 in Washington County. Range's successes were not made public until 2008; however, as rumors spread and ultimately the news of this success became known, a fervor for property to develop quickly emerged, and the competition for acreage caused lease prices to escalate from historical prices of $1 per acre to $500 per acre, then to $1,000 per acre, and then to as much as $10,000 and more per acre. These prices were staggering, and the magnitude of the investment, both in lease acquisition and development costs, set dramatically new levels. In some cases, the significant investment in lease acquisition has driven the new development necessary to hold leases.

In many cases, producers have acquired acreage by purchasing existing leases, which were developed with shallow wells many years ago. Again, the acquisition costs have set unprecedented new levels, and, thus, the value of these leases is high. Buyers assume in each instance that the leases are "held by production." But are they? Stated more specifically, has there been "production" sufficient to extend the term of these old leases or might there have been a cessation or a lack of profitable production which might have caused termination? Looking forward, the boom in new drilling has resulted

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2 Marcellus Shale Advisory Commission, Rep. 2011-01, p. 17, Governor's Report on the Marcellus Shale (2011), *available at* http://www.marcellus.psu.edu/resources/PDFs/MSACFinalReport.pdf.

in a glut of gas on the market and a corresponding drop in prices to the $2 range. Assuming a lease was valid when wells were drilled, what analysis might apply with depressed gas prices and an inability to operate profitably? This chapter explores the requirements for extending the term of an oil and gas lease and the hidden dangers which may cause termination, sometimes unexpectedly.

[1] — The Oil and Gas Lease Term Clause.

From the early days of the oil and gas industry, a standard oil and gas lease has adhered to certain common terms, and one of the core provisions has always been the term clause, which will provide for a "primary term," a finite period stated in days, months or years, and an "extended" or "secondary" term, which will be an indefinite period lasting as long as oil or gas are produced from the leased premises. In its simplest form, an oil and gas lease will provide: "This lease shall have a term of ten years from the date hereof and as long thereafter as oil and gas, or either, are produced from the leased premises." The fixed term of years — in this example, 10 years — is the "primary term," and, if production is obtained, the period "thereafter" is the "extended" or "secondary" term. This term clause will be coupled with a rent clause, which provides for rent, historically in periodic payments, to be made during and to cover the primary term and a royalty clause to provide for payments after production is obtained and during the extended term.

Thus, a primary term allows the lessee a finite period to evaluate the property, arrange for financing as necessary, obtain drilling permits and authorizations, and possibly acquire surrounding acreage that can be supported with the pipeline infrastructure. To extend the lease during the primary term, the lessee must either pay rent or drill a well and obtain production of oil or gas. In order to propel the lease from the primary term to the extended term, a well must be drilled and, generally, production obtained. Thereafter, the lease will be extended so long as oil or gas isproduced.[3] Hence, a lease extended by production is "held by production," or, in common parlance, "HBP." The secondary or extended term, or sometimes

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3 3 Williams & Meyers, *Oil and Gas L*aw 601.4 at 9-10 (1985).