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EVERYTHING IS NOT WHAT IT SEEMS, AND WHAT IT IS, IS BROKEN: RE-DEFINING PRODUCTION IN THE OIL AND GAS LEASE HABENDUM CLAUSE

FISHER LYNN FULTON*

I. Introduction

Oil and gas leases can be simple, or they can be complex. More often than not, litigation arises out of non-specific terms of the lease defined differently by parties with different interests in mind. The production company/lessee wants the right to drill, without ever being obligated to drill. Simultaneously, the owner of the mineral deed/lessor wants the profits of royalty payments that come from the lessee for a producing well. So when lease agreements are litigated, it is difficult to manage all of the competing interests. One area of the oil and gas contract that causes litigation is the satisfaction of the habendum clause. More specifically the word "production" in the habendum clause.

In Oklahoma, production is a term of art. However, the definition of that term of art is anything but definitive. Section I introduces the questions to ponder for the purpose of this paper. Section II provides key information to understanding the terminology of an oil and gas lease, how oil and gas leases work, as well as principles the court applies to answer questions about lease validity. Section III highlights the process used in Oklahoma,

* Fisher Fulton graduated from Southeastern Oklahoma State University, class of 2020, with a major in English Literature and a double minor in History and Business Management. During her time at Southeastern she was a Brad Henry International Scholar and spent a semester in Swansea, Wales studying Medieval Literature. She will graduate from the University of Oklahoma College of Law in May 2023. Her study emphasis includes property, oil and gas, natural resources, and energy law.

and jurisdictions following the same analysis, to determine what production is. Section IV will introduce an alternative to the current definition and legal analysis used in Oklahoma. Lastly, Section V will give a concise summary of the argument.

II. Background and Key Terms

There are a few key concepts one must understand before going further. Oil and gas leases use many terms of art and many clauses that may appear independent, but actually work only in reference to prior clauses. First, we will discuss what the primary term is, and where in the lease it originates. Second, commencement is defined, and the importance of commencement is considered. Third, the secondary term will be introduced along with savings clauses. Fourth, we will discuss the prudent operator standard. Finally, production will be defined.

A. Primary Term

The oil and gas lease is made up of many pieces that fit together to create a very complex legal document. The habendum clause is the portion of the oil and gas lease which sets out the time frame for the lease.[1] It is typical for the habendum clause to allocate for a primary term, also called an exploratory term, and a secondary term.[2] The primary term is defined as the duration in which the lessee has the right to drill but not the obligation to drill.[3] Typically this is defined as a fixed term of years, which can then continue if oil and gas are produced.[4]

The primary term does not have to be defined as a term of years.[5] In *Butler v. Iola*, the gas lease defined the primary term by describing a different lease held by the lessees, which stated that the Butler Iola lease's primary term would last until the lessee no longer held the other lease.[6] This lease did not have a set expiration of the primary term.[7] The contingency with the other lease created the possibility that the lease could continue

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1. John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 336 (Thomson West, 5th ed. 2008).
2. *Id.*
3. *Id.*
4. 2 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 26.4 (Matthew Bender, Rev. Ed.).
5. *See Butler v. Iola*, 100 Kan. 111, 113-14 (Kan. 1917).
6. *Id.* at 113.
7. *Butler v. Iola*, 100 Kan. 111, 113 (Kan. 1917).

operating in the primary term for an indefinite amount of time.[8] The court held the lease valid.[9] One argument was that the lease terms were too indefinite, so much so that the lease should be rendered invalid.[10] However, the court said that "if [the lessor] does not complain that his rights might be arbitrarily terminated or his liabilities unduly extended by the act or conduct of the parties to the other lease, we see no reason why the [lessee] can complain."[11]

The primary term does not require production to maintain the lease.[12] In *P.M. Drilling, Inc. v. Groce*, the lessor argued that the lease was terminated by a failure of the lessee to satisfy the habendum clause.[13] The court looked to the language of the lease to settle the dispute.[14] The relevant lease language was "TO HAVE AND TO HOLD THE SAME FOR A TERM OF ONE YEAR FROM THIS DATE, HEREINAFTER REFERRED TO AS THE PRIMARY TERM, AND AS LONG THEREAFTER AS OIL OR GAS . . . IS PRODUCED THEREFROM."[15] The court ruled that by the language of the lease, the primary term did not require production.[16] However, for the lease to extend into the secondary term production as defined by the lease would be required.[17]

B. Commencement

In order for a lease to extend from the primary term to the secondary term instead of terminating, there are certain requirements that must be met depending on the specific clauses in the lease.[18] Production is not a requirement of satisfying commencement of operations.[19] One such requirement is commencement of drilling operations.[20] However, to call it

8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *See P.M. Drilling, Inc. v. Groce*, 792 S.W.2d 717, 720 (Tenn. Ct. App. 1990).
13. *Id.* at 719-20.
14. *Id.* at 719.
15. *Id.*
16. *Id.* at 720.
17. *Id.*
18. Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Seventh Edition* § 604.1 (LexisNexis Matthew Bender 2018).
19. *See Prowant v. Sealy*, 1919 OK 304.
20. *Breaux v. Apache Oil Corp*., 240 So. 2d 589, 590 (La. Ct. App 1970).

commencing drilling operations is misleading. Commencing operations can be satisfied in many different ways without the drill bit turning.[21]

The drilling rig does not even need to be on location for the commencement clause to be satisfied. In *Moore Oil v. Snakard*, the defendant lessee held a contract with a third party to commence operations.[22] Two days prior to the expiration of the primary term of the lease, the defendant was notified that the third party was not going to commence operations at the site.[23] On the final day of the primary term, the lessee hired four men to come and search for one of the abandoned wells on the property.[24] The bulldozer operator arrived and began to work prior to midnight of that same day.[25] The court ruled that these actions satisfied commencement of operations for the terms of the lease.[26] The court noted that the defendant acted upon a good faith intention to drill the well to completion.[27]

In order to satisfy commencement of operations it is not necessary that the drill bit be turning in the ground. It is not even necessary for a drilling rig to be on site. *Moore Oil v. Snakard* shows that as long at the producer has done something to further the goal of drilling a well to completion, and has done so with good faith, commencement is satisfied. Martin and Kramer state:

> The courts have held that actual drilling by the lessee is not necessary to satisfy the commencement of drilling operations standard. If the lessee has hauled material on the lease, dug slush pits, staked out a drilling site, and obtained a drilling permit, if required, from the appropriate regulatory agency, the courts will almost certainly find that drilling operations have been commenced.[28]

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21. *Compare Breaux v. Apache Oil Corp*., 240 So. 2d 589, (La. Ct. App 1970) (holding that building a board road and turn around satisfied commencement of operations) *with Stolz, Wagner, & Brown v. Duncan*, 417 F. Supp. 552, (WD Okla. 1976) (holding that doing dirt work around the intended drill site satisfied commencement of operations).

22. *Moore Oil v. Snakard*, 150 F. Supp. 250, 256 (WD Okla. 1957).

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.* at 257-58.

27. *Id.*

28. Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Seventh Edition* § 606.1 (LexisNexis Matthew Bender 2018).

Courts in Oklahoma use the method of determining commencement as outlined by Professor Eugene Kuntz. The Oklahoma Court of Civil Appeals noted, after reviewing Kuntz's interpretation of the law and his test for commencement, that it was in line with the court's view.[29] Kuntz states three factors in considering if operations have commenced: (1) acts on the land, (2) good faith intention of the lessee to complete the well, and (3) diligence in continuing drilling operations.[30]

C. Secondary Term

After commencing operations and the expiration of the primary term, the lease enters into the secondary term. There are many ways in which this can occur. Typically lease language that graduates the lease from the primary term requires oil and gas to be producing in paying quantities, the capability of production of oil and gas in paying quantities, or for current operations for oil and gas production.[31] Another way an oil and gas lease may enter the secondary term is via a savings clause.[32] Typical savings clauses for an oil and gas lease include the continuous drilling clause, the continuous operations clause, and the well completion clause to name a few.[33] When the lessee has commenced operations by the end of the primary term but is not yet producing, the lessee must rely on the savings clause to extend the lease into the secondary term.[34]

1. Lack of a Savings Clause

In the absence of any savings provisions, the habendum clause governs the term limits of the lease.[35] If the habendum clause is not satisfied, the lease cannot extend.[36] In *J.J. Fagan & Co. v. Burns*, the primary term of the lease was for one (1) year.[37] Lessee did not begin drilling operations until two (2) days prior to the set expiration date.[38] Lessee argued, although at the expiration of the primary term, oil and gas were not being produced in

29. *21st Century Inv. Co. v. Pine*, 1986 CIV APP 27, ¶24.

30. 3 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 32.3 (Matthew Bender, Rev. Ed.).

31. John S. Lowe, Oil and Gas Law in a Nutshell 186-87 (7th ed. 2019).

32. *Id.* at 187.

33. *See Id.*, *and see* John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 273 (Thomson West, 7th ed. 2018).

34. *See* John S. Lowe, Oil and Gas Law in a Nutshell 251-52 (7th ed. 2019).

35. *See J.J. Fagan & Co. v. Burns*, 247 Mich. 674, 682 (Mich. 1929).

36. *Id.*

37. *See Id.* at 676.

38. *See Id.* at 676-77.

paying quantities, Lessee had the right to drill the well to completion.[39] The relevant parts of the lease contained a habendum clause and a development clause.[40] Lessors argued the habendum clause governed, and the development clause did not serve to extend the lease under these circumstances.[41] The court found in favor of the lessor, ruling the lease was expired.[42] The court said that the greatest weight of authority showed that the habendum clause is the dominating clause when it comes to determining the time limits of the lessee's rights.[43] The court also stated "[a] late start…does not excuse failure to produce."[44] In dicta, the court advised that "[i]n fairness to lessors, extension provisions should be made plain."[45]

2. Inapplicable Savings Clauses

It can be difficult for a lease to enter the secondary term even with savings clauses in the lease. Lessees cannot plan for every imaginable scenario, and savings clauses are often construed strictly and against the lessee.[46] In *Rogers v. Osborn*, the court did exactly that.[47] Lessees completed a well on the expiration of the lease, and it was not producing.[48] The lease expired unless there was an applicable savings clause.[49] Lessees argued the reworking operations and the drilling of a second well saved the lease.[50] The court ruled in favor of the lessor.[51] There was not a savings clause that was exactly tailored to the circumstances.[52] The court construed the dry hole clause, the reworking clause, and the cessation of production clause literally.[53] When this situation arises, the lease cannot be propelled into the secondary term.

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39. *See Id.* at 676.
40. *See Id.* at 676-77.
41. *See Id.* at 678-79.
42. *See J.J. Fagan & Co. v. Burns*, 247 Mich. 674, 682 (Mich. 1929).
43. *See Id.* at 679.
44. *See Id.*
45. *See Id.* at 681.
46. *See* John S. Lowe, Oil and Gas Law in a Nutshell 251 (7th ed. 2019).
47. *See Rogers v. Osborn*, 152 Tex. 540, 546 (Tex. 1953).
48. *See Id.* at 542.
49. *See Id.*
50. *See Id.* at 543.
51. *See Id.* at 546.
52. *See Id.* at 543 and 546.
53. *See Id.* at 546.

3. Multiple Savings Clauses

However, in other instances there can be multiple provisions which may be applicable but ultimately only one prevails.[54] In *Long v. Magnolia Petroleum Co.*, the primary term was set to expire in September 11, 1955.[55] The lease contained an "unless" type delay rental clause.[56] If operations to drill a well were not commenced within the first year of the lease, the lease would terminate unless lessee paid delay rentals to the lessor.[57] Lessor argued that under this provision, the lease had expired because the lessee did not pay the delay rental.[58] On the other hand, Lessee argued the delay rental was not due, as the lease was saved under the reworking and additional drilling clause.[59] Lessee drilled a producing well prior to September 11, 1955.[60] This well produced from November 1952, until December 1954, when production declined in quantity and quality.[61] Lessee placed the well on a pumping schedule in December 1954, in an effort to increase the flow of oil, but the intended results could not be achieved.[62] In February 1955, lessee began to rework the well using the "sandfrac" method, attempting to create new openings for the oil to flow through.[63] Again, lessee's efforts failed to get the well to produce at the previous rate.[64] Although these efforts failed, the well was still producing sellable oil, just not to the same quantity.[65] As a result, the court ruled the lessor's argument that the lease expired for failure to pay the delay rental was without merit.[66] The Lessee had also begun drilling additional wells while still working on the first well.[67] The well never ceased production and therefore the delay rental clause was not applicable.[68] As a result, the reworking and additional drilling clause ruled, not the delay rental clause.[69]

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54. *See Long v. Magnolia Petroleum Co.*, 166 Neb. 410, 430 (Neb. 1958).
55. *See Id.* at 413.
56. *See Id.* at 420.
57. *See Id.* at
58. *See Id.* at 413 and 421.
59. *See Long v. Magnolia Petroleum Co.*, 166 Neb. 410, 421 (Neb. 1958).
60. *See Id.* at 424.
61. *See Id.* at 428-29.
62. *See Id.* at 429.
63. *See Id.* at
64. *See Id.* at
65. *See Id.* at 429-30.
66. *See Id.* at 430.
67. *See Id.* at 431.
68. *See Id.* at
69. *See Id.* at 430-31.

To enter the secondary term, the lessee must have satisfied the habendum clause or an applicable savings clause.[70] Sometimes it is difficult to satisfy a savings clause, because the lease may not contain a savings clause that is directly on point with the circumstances.[71] When this occurs, the lease cannot continue. Similarly, a lease might not contain any savings clauses. In this scenario, the lessee has no other avenue other than to strictly satisfy the terms of the habendum clause.[72] The only way to satisfy the habendum clause in this manner is to have a well that is currently producing before or at the end of the primary term.[73] When there are multiple savings clauses in a lease, the court must turn to the particular facts of the case to determine which savings clause is applicable.[74] By determining which, if any, savings clauses apply the court can determine if the lease is continued into the secondary term or terminated.

D. Prudent Operator Obligation

After the commencement of operations and entering the secondary term, there is a necessary gap between commencement and completion of a well. This gap must be filled with actions taken by the producer that are prudent. Prudent operations are defined as working in a manner that shows good faith intent and due diligence.[75]

The obligation of being a prudent operator during the execution of an oil and gas lease is usually found by the courts to be an implied covenant requiring the lessee to act diligently towards the lessor.[76] This implied covenant requires the operator to act in good faith, competently, and with the lessor's interests in mind.[77] Some view the prudent operator covenant as absolute, while others only apply a test of good faith.[78] However, the majority of jurisdictions view the prudent operator standard as requiring

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70. *See Rogers v. Osborn*, 152 Tex. 540, 542 (Tex. 1953).

71. *See* John S. Lowe, Oil and Gas Law in a Nutshell 251 (7th ed. 2019) *and see Rogers v. Osborn*, 152 Tex. 540, 546 (Tex. 1953).

72. *See J.J. Fagan & Co. v. Burns*, 247 Mich. 674, 678-79 (Mich. 1929).

73. *See Rogers v. Osborn*, 152 Tex. 540, 542 (Tex. 1953).

74. *See generally Long v. Magnolia Petroleum Co.*, 166 Neb. 410, 430 (Neb. 1958).

75. *See Stoltz, Wagner & Brown v. Duncan*, 417 F. Supp. 552, 563-64 (WD Okla. 1976).

76. John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 642 (Thomson West, 5th ed. 2008).

77. John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 642 (Thomson West, 5th ed. 2008).

78. Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Eighth Edition* § 806.3 (LexisNexis Matthew Bender 2020).

more than just good faith.[79] Perhaps the clearest iteration of this view was made by the 8th Circuit Court of Appeals: "[w]hatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required."[80] This version of the standard is extremely similar to the reasonable person standard of tort law.[81]

1. "Continuous" Requirement

Failure to continuously operate on site is not prudent.[82] In *Moore*, the defendant lessee commenced operations prior to the expiration of the primary term.[83] However, after a little more than four months operating continuously the defendant ceased operations.[84] This lapse in operations lasted just over two months.[85] The court found that by ceasing operations, the extension of the primary term ended.[86] "Continuous and diligent operations by the defendant after July 1, 1955, were a condition limiting the extension of the disputed leases."[87] The court decided that defendants' conduct was "prudent and diligent" prior to ceasing operations.[88] It follows that by ceasing operations the defendant in *Moore* became imprudent, because an element of prudent operations is continuous operations. Further, any lapse in operations must be reasonable.[89]

Continuous operations do not require physical or symbolic presence on the lease premises.[90] In *Blair v. Nw. Ohio Nat. Gas Co.*, the lease was set to expire in February 1895, unless the yearly payment of $100 was paid prior.[91] In December of 1894, the single gas well on the property stopped producing.[92] Later that month, the lessee built a rig over the well in order to

79. *See Id.* at

80. *Brewster v. Lanyon Zinc Co.*, 140 F. 801, 814 (8th Cir. 1905).

81. Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Eighth Edition* § 806.3 (LexisNexis Matthew Bender 2020).

82. *See Moore Oil v. Snakard*, 150 F. Supp. 250, 258 (WD Okla. 1957).

83. *See Id.*

84. *See Id.* at 256-57.

85. *See Id.* at

86. *See Id.* at 258.

87. *Id.*

88. *See Id.* at 257-58.

89. Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Seventh Edition* § 618.3 (LexisNexis Matthew Bender 2018).

90. *See Blair v. Nw. Ohio Nat. Gas Co.*, 12 Ohio C.C. 78, 85 (Cir. Ct. 1896).

91. *See Id.* at 83-84.

92. *See Id.* at 83.

pull tubing, clean the well, and drill deeper to improve the well.[93] This continued for six weeks, until it was determined to be an impractical endeavor.[94] By this time, the yearly payment was due to the lessor.[95] Upon delivery of the payment, lessee asked lessor where would be a good location to drill a new well.[96] Lessor did not show any inclinations of believing the lease had expired.[97] From this point, the lessee began developing plans for the new well and began physical operations of drilling in April.[98] Lessor argued that when the original well stopped producing, the lease was terminated.[99] The court ruled that the lessees endeavored continuous operations to fix the existing well, and then to drill a second well even though they were not on the lease land at all times.[100] As a result, these continuous operations extended the life of the lease.

2. "Good Faith" Requirement

Operations must be continuous. However, the lessee's timeline doesn't need to meet any expectations so long as it is done in good faith.[101] In *Son-Lin Farms v. Dyco Petroleum Corp.*, defendant operator did not make the decision to drill until about 10 days prior to the end of the primary term of the lease.[102] However, once the decision was made, the defendant began to search for a deep drilling rig to contract.[103] The rig the lessee was able to secure was not intended to drill past a depth of 12,000 feet, but was rated to go to 15,000 feet deep when used with great care.[104] Plaintiffs argue the slow drilling was representative of the defendant's imprudence and bad faith.[105] The court ruled the defendant *did* act prudently when searching for a drilling rig.[106] "[T]he Defendants had the good faith intention to unqualifiedly drill the well . . . to completion in the Atoka formation which

93. *Blair v. Nw. Ohio Nat. Gas Co.*, 12 Ohio C.C. 78, 83 (Cir. Ct. 1896).
94. *See Id.*
95. *See Id.*
96. *See Id.*
97. *See Id.* at 84.
98. *See Id.*
99. *See Id.*
100. *See Id.*
101. *See Moore Oil v. Snakard*, 150 F. Supp. 250, (WD Okla. 1957), *and see Son-Lin Farms v. Dyco Petroleum Corp.*, 589 F. Supp. 1 (WD Okla. 1982).
102. *See Son-Lin Farms v. Dyco Petroleum Corp.*, 589 F. Supp. 1, 2 (WD Okla. 1982).
103. *See Id.*
104. *See Id.* at 3.
105. *See Id.*
106. *Son-Lin Farms v. Dyco Petroleum Corp.*, 589 F. Supp. 1, 3 (WD Okla. 1982).

in fact they did."[107] Not only was the search for the rig prudent operation, the slow drilling process was also found to be prudent operation done in good faith.[108] While the court noted that it would have been imprudent for the defendants to use a deep drilling rig to slow operations, without a deep drilling rig, it was responsible and prudent to take things slow.[109]

In the case of *Geier-Jackson, Inc. v. James*, the oil and gas lease between the lessor and the lessee stated in part that if drilling was not commenced then the lease would be terminated.[110] The land was in 'wildcat' country, meaning no oil and gas had been discovered in the surrounding tracts of land.[111] Lessee was waiting to develop on lessor's land until after a well was set up on a nearby tract with a different owner. In the meantime, a road was built on lessor's land to the location of the future well.[112] At the expiration of the oil and gas lease primary term, lessee had done nothing more than build the road to the location.[113] Lessor alerted lessee that the lease was expired and brought suit.[114] The court found in favor of the lessor, ruling that the oil and gas lease had expired.[115] Even though the lessee built the road to the location of the future well, he stopped further operations until he knew the results of the well on the neighboring tract of land.[116] Lessee made the decision to begin operations again dependent on the success or failure of a well on different property than was subject to the lease.[117] This action was not taken with "the good faith intention to pursue with the standard of diligence set forth" in the oil and gas lease.[118]

From the *Son-Lin* case we can add to our definition of prudent operations responsible acts with the intent to complete a well. *Geier-Jackson* qualifies this intent. The intent must not be dependent upon the success or failure of another well. If it is found that an operator based his decision to drill to completion or not in order to continue operations in the secondary term on another's actions, then the operator did not act within the constraints of the implied covenant of prudent operations.

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107. *See Id.*
108. *See Id.*
109. *See Id.* at 4.
110. *Geier-Jackson, Inc. v. James*, 160 F. Supp. 524, 525 (E.D. Tex. 1958).
111. *See Id.* at 527.
112. *See Id.*
113. *See Id.*
114. *See Id.* at 528.
115. *See Id.* at 520-31.
116. *See Id.* at 527-30.
117. *Geier-Jackson, Inc. v. James*, 160 F. Supp. 524, 529 (E.D. Tex. 1958).
118. *See Id.* at 529 -30.

A prudent operator acts with good faith intent to unqualifiedly complete a well diligently, continuously, and responsibly. As long as these conditions are met, the lease will be extended past the primary term at least to completion of the well.[119] However, as soon as one of these conditions is no longer met, the operator runs the possibility of losing the lease.[120] These requirements of acting with good faith, due diligence, continuity, and responsibility are the same factors that Kuntz says an operator needs to satisfy commencement.[121] If an operator continues to act in the same manner from satisfaction of commencement to satisfaction of completion, the gap will have been filled with prudent operation.

Two final notes to bear in mind when thinking about prudent operations is that there are certain exceptions to continuity and the gap between completion of a well and production. There can be cessation of operations that are specifically allowed by provisions in the oil and gas lease.[122] One example of such a provision is the shut-in royalty clause.[123] Second, just as there is a gap between commencement and completion, there is likewise a gap between completion and production.[124] This gap must be filled with prudent operations in the same manner as the gap between commencement and completion.

E. Production

The lease can extend out of the primary term and into the secondary term if it provides for an extension via production.[125] To be more specific, with regards to the habendum clause, production means production in paying quantities, or economically viable to continue production.[126]

To produce in paying quantities is to have the well pay in excess of its operating costs.[127] In *Clifton v. Koontz*, lessee's well produced both oil and

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119. *See Son-Lin Farms v. Dyco Petroleum Corp.*, 589 F. Supp. 1 (WD Okla. 1982).

120. *Compare Moore Oil v. Snakard*, 150 F. Supp. 250, (WD Okla. 1957) *with Son-Lin Farms v. Dyco Petroleum Corp.*, 589 F. Supp. 1 (WD Okla. 1982).

121. 3 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 32.3 (Matthew Bender, Rev. Ed.).

122. Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Seventh Edition* § 618.3 (LexisNexis Matthew Bender 2018).

123. Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law Abridged Seventh Edition* § 616.4 (LexisNexis Matthew Bender 2018).

124. *See Id.* at § 618.2.

125. John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 365 (Thomson West, 5th ed. 2008).

126. *See Id.*

127. *See Clifton v. Koontz*, 160 Tex. 82 (Tex. 1959).

gas.[128] However, the amount of oil and gas that was the product of this well was relatively small, which resulted in the lessor arguing the lease was terminated via failure to produce during the range of months cited.[129] The total loss for the time period cited by the lessor was $216.16.[130] The court ruled in favor of the lessee, finding that the well was still producing.[131] In reaching this conclusion, the court said that with a marginal well you must look to whether or not a reasonable operator would continue the well under the relevant circumstances for purposes more than mere speculation.[132]

> Some of the factors are: The depletion of the reservoir and the price for which the lessee is able to sell his product, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes.[133]

Applying such factors and stating that depreciation is not an expense for purposes of determining paying quantities, the court ruled that the well was producing over a period of time.[134]

The meaning of production for purposes of the habendum clause can be defined simply as a well paying out more money than the operator is putting into the well over a reasonable period of time. *Clifton v. Koontz* qualifies production further when contemplating a marginal well. Not only does one look to profit and loss, but one must also consider any other reason that a prudent operator would continue to operate a marginal well in that area. Without any other savings clause in the oil and gas lease, the rights of the lessee to operate live and die by the habendum clause. More specifically, the lessee's operative rights live and die by the way that production is defined in the habendum clause regardless of production's definition in separate clauses in the oil and gas lease.

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128. *See Id.*
129. *See Id.* at 86.
130. *See Id.*
131. *See Id.* at 90.
132. *See Id.*
133. *Clifton v. Koontz*, 160 Tex. 82, 90 (Tex. 1959).
134. *See Id.*

F. Tying It Together

Oil and gas leases contain many different clauses that all work together. Some, such as the continuous drilling clause, operate in the best interest of the lessee. Others, such as the delay rental clause, operate mainly for the best interest of the lessor. While others still, such as the shut-in royalty payment clause, operate in the best interest of both the lessee and the lessor. The habendum clause is the term clause.[135] This clause sets out the primary term of the oil and gas lease.[136] This is the period of time in which the lessee has the right to drill an oil and gas well.[137] Barring lease language to the contrary, the lessee is not required to drill during this time.[138] If the habendum clause is satisfied, the lease automatically enters the secondary term.

Commencement is a necessary element to satisfy the habendum clause and necessary to satisfy a savings clause. Commencement of drilling operations does not require actual drilling.[139] Instead, it requires the operator to undertake necessary steps with the intent to drill a well to completion. This can be, but is not limited to, actions such as clearing land for a road to the drill site, staking out a drill location, building a turnaround, locating a drilling rig, etc.[140] Three key factors to be looked at in determining if commencement of operations has occurred are: (1) acts on the land, (2) done with the intent to complete the well, and (3) diligent continuous operations.[141] Commencement is a key element of satisfying the continuous operations clause as well as the continuous drilling clause.

In the event the habendum clause is not satisfied, the lease can only be propelled into the secondary term by a savings clause.[142] There are many different savings clause provisions, however there may not always be an

135. *See* John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 226 (Thomson West, 7th ed. 2018).

136. *Id.*

137. *Id.*

138. *See P.M. Drilling, Inc. v. Groce*, 792 S.W.2d 717, 720 (Tenn. Ct. App. 1990).

139. *See Stolz, Wagner, & Brown v. Duncan*, 417 F. Supp. 552, (WD Okla. 1976)

140. *Compare Breaux v. Apache Oil Corp*., 240 So. 2d 589, (La. Ct. App 1970) (holding that building a board road and turn around satisfied commencement of operations) *with Stolz, Wagner, & Brown v. Duncan*, 417 F. Supp. 552, (WD Okla. 1976) (holding that doing dirt work around the intended drill site satisfied commencement of operations).

141. *See* 3 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 32.3 (Matthew Bender, Rev. Ed.).

142. *See J.J. Fagan & Co. v. Burns*, 247 Mich. 674, 682 (Mich. 1929).

applicable one in the lease.[143] In the event that there is no savings clause, the lease will be terminated at the end of the primary term.[144] If there is an applicable savings provision, then the lease will enter the secondary term.[145] However, without actual production the lease will only remain in the secondary term as long as the operator is prudent.

The obligation to operate prudently is an implied covenant within the oil and gas lease.[146] Being a prudent operator entails many things. A prudent operator handles themselves and the lease in good faith and due diligence.[147] To operate with good faith, operations must be continuous.[148] However, the oil and gas lease usually has provisions that allows for short breaks in operation for reasonable interruptions. Although operations must be continuous, they need not always be on site operations.[149] There are necessarily some planning operations that can be done, and sometimes *must* be done, off site. The fact that the operator is off site periodically does not mean that operations are not continuous. Similarly, the operator need not operate in a manner that the lessor deems fit. As long as the lessee operates in a manner that shows good faith intentions towards completing the well, and thus satisfying the motivations of the lessor, the operator is acting prudently. Slow operations, as long as they are done with good faith, are also prudent. The intent to drill a well to completion cannot be contingent upon factors that involve another lease.[150] Part of having a good faith intent is weighing the motivations of the lessor against the lessee's own motivations.

Production is necessary for the lease to continue indefinitely. However, production does not mean any amount of oil or gas. Production means oil and/or gas in paying quantities, or in amounts that make the well economically viable.[151] The total amount of sales must exceed operating

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143. *See generally J.J. Fagan & Co. v. Burns*, 247 Mich. 674, 681-82 (Mich. 1929), *and see Rogers v. Osborn*, 152 Tex. 540, 543 and 546 (Tex. 1953).

144. *See Rogers v. Osborn*, 152 Tex. 540, 543 and 546 (Tex. 1953).

145. *See id.* at 542.

146. *See See* John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 427 (Thomson West, 7th ed. 2018).

147. *See Stoltz, Wagner & Brown v. Duncan*, 417 F. Supp. 552, 563-64 (WD Okla. 1976).

148. *See Moore Oil v. Snakard*, 150 F. Supp. 250, (WD Okla. 1957).

149. *See Blair v. Nw. Ohio Nat. Gas Co.*, 12 Ohio C.C. 78, 85 (Cir. Ct. 1896).

150. *See Son-Lin Farms v. Dyco Petroleum Corp.*, 589 F. Supp. 1, 4 (WD Okla. 1982).

151. *See* John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 365 (Thomson West, 5th ed. 2008).

costs.[152] This is not determined based on a specific instance in time though, instead it is examined over a period of time as necessarily price changes and oil flow fluctuate constantly.[153] For a marginal producing well, you must also look at other factors that would convince a prudent operator to continue operating the well.

Lastly, there is a necessary gap between completion of a well and when the well begins to produce in paying quantities. When this gap occurs during the primary term, the lessee is protected from termination. However, when this happens outside of the primary term the lessee can face termination of the lease. This is the area of the oil and gas lease where savings clauses matter most, and similarly the area of focus for this paper. During this period of time the operations must not lapse unless there is lease language to the contrary. A lessee will be given a 'reasonable' amount of time to transition the well from a completed well to a producing well. But how does one determine what is a reasonable amount of time? Generally, it is easy to say that if a year has passed and the well is still not producing that it is an unreasonable amount of time. Likewise, if only a few weeks have passed and the well is still not producing, that this is still within a reasonable timeframe. There is little that provides clear commentary on this matter. So which party should be given the protection of the courts? Lease language is usually construed strictly against the lessee, following a principle of contract law that the party who writes the contract will have the language elucidated against them. However, this clashes with the property law principle that land should be as productive as possible.

III. Current Approach

The current analysis used by the courts to decide if a lease that is not producing has been terminated has multiple steps. Each step has multiple moving parts that depend on the specific facts of the case as well as the specific language in the lease. The burden of proof is on the lessor to prove that an operation is not productive.[154] The first step is to determine if the lease has successfully entered the secondary term. The second step, which includes a two-part test, is to determine if the operation is productive. The third and last step is taken with regards to the limited guidance on the length of a reasonable period of time.

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152. *See Clifton v. Koontz*, 160 Tex. 82 (Tex. 1959).

153. *Id.*

154. 2 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 26.7(h) (Matthew Bender, Rev. Ed.).

A. Step One

The first step in this approach is to determine if the lease has reached the secondary term. If the lease is still in the primary term, production does not affect the validity of the lease. During the secondary term, production does affect the validity of a lease. How the lease reached the secondary term also matters. When a lessee is able to drill and complete a well during the primary term, and that well then produces in paying quantities, at the expiration of the primary term the lease will automatically enter into the secondary term by the terms of the habendum clause. When this occurs, the first step of the analysis is shorter. To move the analysis along, the court only needs to determine if the habendum clause of the lease was satisfied.[155] If production was not reached during the primary term, and a savings clause was applicable to propel the lease into the secondary term, the court must first determine if the savings clause did in fact apply.

B. Step Two

Step two is to determine if an oil and gas well has produced. Step two has two subparts, first an objective test and second a subjective test. Both tests are subject to a reasonable period of time. First, we will discuss each subpart and then focus on how courts determine what a reasonable period of time is.

1. The Objective Test

The objective test asks a simple question, "do revenues exceed operating expenses?" Whether or not the well ever pays out has no consequence in the analysis. Stated another way, "[i]f the well pays a profit even though small, over operating expenses, it produces in paying quantities, though it may never repay its costs, and the operation as a whole may prove unprofitable."[156]

Operating expenses include many things, but in general it can be simplified as stating that operating expenses are the required costs of lifting the oil from the earth. For this reason, operating expenses are sometimes called lifting costs. The Kansas Supreme Court defined lifting costs as follows:

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155. *See Transport Oil Co. v. Exeter Oil Co.*, 191 P.2d 616, 617-18 (Cal. Ct. App. 1948), *and see Henry v. Clay*, 1954 OK 170, ¶ 7-8 (Okla. 1954).

156. *Henry v. Clay*, 1954 OK 170, ¶ 6 (Okla. 1954).

> These direct costs include labor, trucking, transportation expense, replacement and repair of equipment, taxes, license and permit fees, operator's time on the lease, maintenance and repair of roads, entrances and gates, and expenses encountered in complying with state laws which require the plugging of abandoned wells and prevention of pollution.[157]

There are some expenses that may seem like they should be included in lifting costs, but in fact are not. The initial costs to the lessee to drill the producing well are not taken into consideration for this analysis.[158] Although the initial cost of equipment to pump the well is not included in lifting costs, some courts include depreciation of the equipment in lifting costs.[159]

Essentially, for the objective test you would take the price that the oil or gas was purchased for and subtract royalties and lifting costs.[160] If the difference is positive, then the well is producing in paying quantities.[161] If the difference is negative or zero, then the well is not producing in paying quantities.[162] However, the revenues and expenses are to be looked at across a span of a reasonable amount of time, not just a specific month.[163] This is because oil and gas wells are subject to wide ranges of fluctuation, depending on factors such as the flow of the well, the price of oil and gas, and the general economy.[164] If it is decided that the lease is producing, then there is no need to move on and do the subjective test, and the analysis ends there. In the event that the lease fails the objective test, then the court moves on to the subjective test. There is no set of circumstances however that cessation of production alone will terminate a lease, which is why the subjective test is necessary.[165]

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157. *Reese Enterprises, Inc. v. Lawson*, 220 Kan. 300, 314-15 (Kan. 1976).

158. *See Stewart v. Amerada Hess Corp.*, 1979 OK 145, ¶ 6 (Okla. 1979) *and see Reese Enterprises, Inc. v. Lawson*, 220 Kan. 300, 314 (Kan. 1976).

159. *See Stewart v. Amerada Hess Corp.*, 1979 OK 145, ¶ 9 (Okla. 1979) *and see Whitaker v. Texaco, Inc.*, 283 F.2d 169, 176, (10 Cir. App. 1960), *but see Texaco, Inc. v. Fox*, 228 Kan. 589, 594 (Kan. 1980) *and see Reese Enterprises, Inc. v. Lawson*, 220 Kan. 300, 314 (Kan. 1976).

160. *See Henry v. Clay*, 1954 OK 170, ¶ 8 (Okla. 1954).

161. *See Id.*

162. *See Id.* at ¶ 11.

163. *See Transport Oil Co. v. Exeter Oil Co.*, 191 P.2d 616, 623-24 (Cal. Ct. App. 1948).

164. 2 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 26.7(u) (Matthew Bender, Rev. Ed.).

165. *See Stewart v. Amerada Hess Corp.*, 1979 OK 145, ¶ 11, (Okla. 1979).

2. The Subjective Test

When there is a failure to produce in paying quantities, the court then asks if this failure is reasonable and justified in the light of all the circumstances. The main case courts look to when applying this subjective test is *Clifton v. Koontz*. In that case the court said:

> In the case of a marginal well, such as we have here, the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated.[166]

In short, the subjective test looks to see if there is any reason that a well might not be producing, but a prudent operator would continue to operate the well because they believed it would begin producing again.

There are many reasons why a well may temporarily stop producing. For example, after a period of time the reservoir the oil is being extracted from will drop to a level that no longer produces oil in paying quantities.[167] In a situation such as this, it may be prudent to temporarily stop pumping to raise the level of the reservoir once more.[168] Similarly, the price of oil may fall so low for a period that even if the well produces the same number of barrels per day, it is no longer enough to exceed operating costs.

3. The Objective and Subjective Tests Working in Tandem

In practice, the two tests actually fit together like one step. Consider the following case, *T.W. Phillips Gas & Oil Co. v. Jedlicka*. Lessor sought for forfeiture of the oil and gas lease on the grounds of lack of production in paying quantities.[169] Lessee maintained that they operated the lease in a manner which produced in paying quantities and that was in good faith to produce a profit.[170] Lessor wanted to invalidate an 80-year-old lease over the fact that in one single year, 1959, Lessee failed to produce a profit and suffered a loss of $40, even though that single year was over 45 years prior.[171] The lessor argued that there was no need to determine the

166. *Clifton v. Koontz*, 160 Tex. 82, 89 (Tex. 1959).
167. *See Ballanfonte v. Kimbell*, 373 S.S.2d 119, 120 (Tex. Civ. App. 1963).
168. *See Ballanfonte v. Kimbell*, 373 S.S.2d 119, 120 (Tex. Civ. App. 1963).
169. *See T.W. Phillips Oil & Gas Co. v. Jedlicka*, 615 Pa. 199, 204 (Pa. 2012).
170. *See Id.* at 204-05.
171. *See Id.* at 204 & 225.

subjective factors of good faith after it was established that the lease failed to produce in paying quantities in 1959, the good faith analysis should only be done if the lease passes the objective test.[172] Lessee argued that the prevailing authoritative case requires such consideration of an operator's good faith.[173] The Pennsylvania Supreme Court ruled that the lease was valid.[174] Further, the court said that when determining if a marginal or sporadic well is producing in paying quantities, examining the good faith intention of the operator is required.[175] Directly condemning the lessor's argument, the court stated "the test for determining in paying quantities could never be *purely* objective."[176] It is the burden of the Lessor to establish that the lessee acted in bad faith.[177] While the evidence showed a period of one year that the lease had operated at a loss, the lessor failed to satisfy the burden showing that the lessee operated in bad faith.[178]

Consider the following Oklahoma case as an example of bad faith intentions. When no equitable reasons are present to support a well being shut down, such actions would be the result of bad faith intent.[179] In *Hunter v. Clarkson*, the primary term of the lease was set to expire on Dec. 12, 1961, unless oil or gas were being produced.[180] The trial court determined as a fact that production ceased for five months after the expiration of the primary term, resulting in the termination of the lease by its own terms.[181] The Oklahoma Supreme Court stated that the specific circumstance in this case showed that the cessation of production was purely voluntary.[182] An operator cannot produce oil only at times where it fits his needs.[183]

C. Reasonable Period Guidance

Courts are hesitant to establish a hard-and-fast rule as to what defines a reasonable period of time to look at when determining if a lease is producing in paying quantities. In *T.W. Phillips Gas & Oil Co.*, the court said "with regard to what constitutes a reasonable time period by which to

172. *See Id.* at 215-16.
173. *See Id.* at 215.
174. *See Id.* at 203.
175. *See Id.* at 224.
176. *See Id.* at 221-22.
177. *See T.W. Phillips Oil & Gas Co. v. Jedlicka*, 615 Pa. 199, 207 (Pa. 2012).
178. *See Id.* at 225-26.
179. *See Hunter v. Clarkson*, 428 P.2d 210, 212 (Okla. 1967).
180. *See Id.* at 211.
181. *See Id.* at 212.
182. *See Id.*
183. *See Id.* at 213.

determine whether a well is profitable, we decline to establish a definite rule."[184] Instead, to determine what length period of time is appropriate should be determined by looking at the totality of the specific circumstances of each case.[185] Courts reason that looking at profits and losses of a lease over a reasonable period is necessary.[186] This is so that normal fluctuations such as unusual maintenance, the price of oil, etc. can even out over time, giving the court a better idea of the overall profitability of a lease.[187] The Texas Supreme Court in *Koontz*, felt so strongly about this idea that it said "[w]e again emphasize that there can be no limit as to time, whether it be days, weeks, or months, to be taken into consideration in determining the question of whether paying production from the lease has ceased."[188]

There being no set rule for determining a reasonable period of time, it leaves decisions based on varying periods of time. In one case, a period of thirteen years was found unreasonably long.[189] Another case found a period of fourteen months to be reasonable.[190] It is widely accepted that a period of no less than one year should be considered, however, beyond that it is generally determined by the trial court depending on the circumstances of each case.[191] With this little guidance on what constitutes a reasonable period of time, it makes it difficult for both the lessee and the lessor to have an assurance of their rights. The Supreme Court of Oklahoma stated in *Hunter v. Clarkson* "[t]he landowner has an interest which must, and will, be protected when the operator ceases production [f]or an unreasonable time, without cause, after the expiration of the primary term."[192] With no guidance of what a reasonable period for determination of production is

184. *See T.W. Phillips Oil & Gas Co. v. Jedlicka*, 615 Pa. 199, 222 (Pa. 2012).

185. *See Ross Expls., Inc. v. Freedom Energy, Inc.*, 640 Ark. 74, 81 (Ark. 2000), *and see Barby v. Singer*, 648 P.2d 14, 16-17 (Okla. 1982), *and see Fisher v. Grace Petroleum Corp.*, 830 P.2d 1380, 1386 (Okla. Civ. App. 1991) *and see* 2 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 26.7(u) (Matthew Bender, Rev. Ed.).

186. *See Transport Oil Co. v. Exeter Oil Co.*, 191 P.2d 616, 623-24 (Cal. Ct. App. 1948).

187. *.See Id.*

188. *See Clifton v. Koontz*, 160 Tex. 82, 89 (Tex. 1959).

189. *See Texaco, Inc. v. Fox*, 228 Kan. 589, 593 (Kan. 1980).

190. *See Barby v. Singer*, 648 P.2d 14, 16 (Okla. 1982).

191. *See* John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 270 (Thomson West, 7th ed. 2018).

192. *Hunter v. Clarkson*, 428 P.2d 210, 213 (Okla. 1967).

other than more than one year but less than thirteen years, the lessor has a difficult time knowing if they even have a case with merits.[193]

IV. Suggested Approach

Oklahoma's dependance on "production" as a term of art, as well as the poorly defined "reasonable period of time" is a confusing method and results in a poorly structured legal analysis. Many courts across the nation rely on analyses that are far less confusing. For example, Kansas uses only the objective test, while applying the same definition of "producing."[194] However, this method still creates uncertainty among the lessor and the lessee. The lessee has no guarantee that even if prudent operators would continue the lease that they themselves will be protected by the court. The lessor has no guidance on how long an unreasonable cessation of production is.

In the early twentieth century, West Virginia took the view that the purpose of the oil and gas lease was that the lessor could obtain the required diligence and skill necessary to obtain oil and gas.[195] West Virginia did not see "production" as a term of art meaning producing in paying quantities. Instead, "produced" simply meant "as long as the premises are diligently and efficiently operated, provided minerals shall have been discovered within the fixed term."[196] The reasoning behind this view is similar to the reasoning behind the "paying quantities" view, to honor the purpose of the agreement. However, paying quantities jurisdictions view the purpose of the lease as making land productive, and if it is not producing oil or gas in paying quantities then it is not being productive.

Kentucky takes yet another view on the meaning of production in the habendum clause. This view is similar to both West Virginia and Oklahoma by striking a balance between the two. Kentucky's view is that "produced" in the habendum clause does not necessarily mean that it is producing in paying quantities so that revenues exceed the lifting costs.[197] A mere showing of oil does not satisfy production, but instead there must be enough that it is "susceptible of division" so that the lessee can pay a

193. *See* John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 270 (Thomson West, 7th ed. 2018), *and see Texaco, Inc. v. Fox*, 228 Kan. 589, 593 (Kan. 1980).

194. *See Reese Enterprises, Inc. v. Lawson*, 220 Kan. 300, 313-14 (Kan. 1976).

195. *See South Penn. Oil Co. v. Snodgrass*, 71 W. Va. 438, 450-51 (W. Va. 1912).

196. *See Id.* at 451.

197. *See Enfield v. Woods*, 198 Ky. 328, 329 (Ky. 1923).

royalty to the lessor.[198] Even if the royalty is small, as long as a royalty can be paid production is satisfied.[199]

A. The Problem in Oklahoma

The current method in Oklahoma is unpredictable unless there is a prior case on record that is exactly on point with the specific facts of a current dispute. The reliance on both an objective and subjective test is very operator friendly. At face value, turning the word "production" into a term of art that means producing in paying quantities seems like it would favor the mineral rights owner. However, the definition of paying quantities tips it back, even if it is just slightly, in the favor of the lessee. The well never has to pay for itself, only minimal operating expenses, and royalty payments. It may seem like an operator's safe haven, but that is not exactly the case. At the same time, the requirement that a well must produce in paying quantities puts an emphasis on the public interest in the production of energy, actualized as oil and gas.

For the lessee, although the method seems rather operator friendly, it still leaves questions without answers. While there are industry standards for reasonable cessation of production, each well behaves differently. If you are operating a well that takes just a little bit longer for the reservoir to reach minimum pump levels again, you are unsure if you are protected by the subjective method. In a separate vein, an operator may see value in continuing to operate a lease with only marginal wells. However, if the operator's reason is anything other than the well's eventual production in paying quantities, it is deemed bad faith intent.

For the lessor, it's even more confusing. There is a general lack of guidance as to what a reasonable period is for determining if a lease is producing in paying quantities. While it is generally said that the period is not less than one year, that is not a hard rule. A period of less than one year could be looked at if a court deemed it fair. Similarly, it is not uncommon for a single oil and gas lease to span multiple generations.[200] At any point if the lease stops producing, it is difficult for the lessor to bring suit. For example, if an 80-year lease was producing up until the last year and a half before the lease expired, there is little to suggest to the lessor that the court would view that year and a half as having more weight than the prior 78½ years. But how many years does the well have to not produce before the

198. *See Enfield v. Woods*, 198 Ky. 328, 329-30 (Ky. 1923).
199. *See Id.*
200. *See T.W. Phillips Oil & Gas Co. v. Jedlicka*, 615 Pa. 199, 203 (Pa. 2012).

court will deem that number of years as more important than the 80 years prior when the well was producing? The law fails to answer these questions. It also fails to address if the period of years that a well has been producing changes the analysis. The above scenario would suggest that a multi-generation well is given more protections that a new well.

Finally, the current method in Oklahoma leaves far too much room for a judge to use their discretion. Ultimately, the judge decides what the determinable period of time will be for production. Even during a jury trial, the judge determines what period of time evidence must be pulled from. Courts serve the purpose of making the law clear, using methods that provide stability. One of the main functions of the law is to create uniformity in the law. Oklahoma's poor method of analysis does anything but create uniformity in the decisions of the court. Worst of all, there is little room for a trial court decision to be overturned unless the appellant can prove that the trial court judge abused his/her discretionary power.

B. The Issue with the West Virginia View

The West Virginia view, similar to Oklahoma, is very lessee friendly. This analysis turns on two objective questions. First, has oil or gas been discovered in the primary term?[201] Second, is the lessee operating the lease diligently, and with the requisite skill level?[202] The lessee need only to show there is oil or gas present to extend the lease past the primary term and into the secondary term with this loose definition of "produced." Lessors on the other hand, are left with few options to contest the validity of a lease on the grounds of lack of production.

A lessor must show one of two things to prevail on ground of no production. Either that there has been no discovery of oil or gas.[203] Or, that the lessee is not operating the lease effectively or diligently.[204] This requirement to show that the lease is not being operated within industry standards is comparable to the Oklahoma standard requirement of a prudent operator.

This method of analysis does not promote productivity of land. It does not provide an incentive to the lessee to develop oil and gas wells, because as long as they are working diligently, they are protected. If the well is not producing in paying quantities, then the lessor will not receive royalties for the oil or gas. While all oil and gas leases are essentially just a contract for

201. *See South Penn. Oil Co. v. Snodgrass*, 71 W. Va. 438, 451 (W. Va. 1912).
202. *See South Penn. Oil Co. v. Snodgrass*, 71 W. Va. 438, 451 (W. Va. 1912).
203. *Id.*
204. *Id.*

the mutual benefit of the lessor and the lessee, the view of West Virginia virtually gives the lessee all the power. A lessee would be able to maintain a well for purely speculative purposes or hold the lease just so a competitor would not be able to hold the lease. Ultimately, this method provides virtually no protections for lessors or their payments. Similarly, it does not promote the public's interest in the production of oil and gas for consumers.

C. The Issue with the Kentucky View

The Kentucky method is the friendliest so far to lessors. This view protects a lessor's interest in royalty payments from oil or gas. It seems to borrow from both prior methods with minor changes. Not using the paying quantities limitation makes the method friendly to lessees, but the new limitation, that the amount produced needs to be enough to make a royalty payment, makes it also friendly to the lessor.

The issue with this method of analysis ultimately comes from the fact that it does not strictly enforce the productivity of land. It requires more productivity than the West Virginia view, but not as much as the Oklahoma view. The balance works well for the competing interests of the lessor and the lessee, but it leaves the public interest in the production of energy materials with something to want. This method still only requires a minimum effort of lease operators, which in turn means the land is not being as productive as it could be. This method is friendly to the marginal or sporadic well but does not require the operator to improve upon the well in a way that under the Oklahoma method would be required of a prudent operator.

D. Managing Interests

Each of the three methods discussed above has its pros and cons. The perfect method would balance the interests of the lessor, lessee, and public interest equally. However, we do not live in a perfect world with an infallible court system. If the perfect legal analysis could be developed, it would require a higher level of production than West Virginia or Kentucky to protect the public interest. To protect the lessor's interests, it would require production in paying quantities similar to that of Oklahoma, but with stricter guidelines. To protect the interests of the lessee, the analysis would contain a grace period past the primary term similar to Kentucky's analysis while incorporating a subjective test similar to Oklahoma after the grace period ends. In all instances it would require that there be a showing of oil or gas for the lease to extend into the secondary term and follow the same operator standards as required by West Virginia.

1. Public Interest Protection

The Oklahoma method defines production in the habendum clause as production in paying quantities. For this threshold to be met, the operator must be making a profit. This requirement means that there would be enough oil or gas being lifted that it is substantially providing the product for the energy market. The general public has an interest in this kind of work being done so that they can consume the product. Most consumers do not realize the extent that oil and gas is needed, and how much is needed, to go about their daily lives in their usual manner. Gas is needed to heat our homes, cook our food, heat our water, dry our clothes, and many other daily purposes. Oil is needed to keep our cars running, construct buildings, create electronics, created household goods, and many other things. Our culture of consumerism demands that these types of goods and services be available to us almost 24 hours a day, 7 days a week, 365 days of the year. Because of this consumer culture, the public has a strong interest in the active production of oil and gas.

The requirement that oil and gas be produced on a lease in paying quantities satisfies this public interest in a few ways. First, it motivates the operator. If the lessee is not diligently working the lease in a manner that results in producing wells, the lessee will lose the lease. Second, if the lessee is not working to make a profit at a lease, a competitor will come in and do it instead. The demand of consumerism creates many competitors, and if one operator will not do the job, a lessor can be assured that another operator will. So, a lessee may work prudently to keep competitors from a particular lease, or they may not work prudently and someone else will.

2. Lessor Interest Protection

A lessor has an interest in getting paid for leasing out their mineral interests. A lessor also has an interest in leasing to a prudent, diligent, and skillful operator. This is because a prudent operator will extract more oil or gas form the property, thus making the lessor's royalty check larger. The requirement that oil and gas be produced in paying quantities satisfies this interest, but it puts a heavy burden on operators. While offering less protection, the Kentucky method manages to protect the lessor's interests while creating less of a burden on the operator.

The lessor's main interest is in the benefits they receive from the production of oil or gas on their property. This is not only royalty payments, but can also include bonuses, free gas, and more. If a lease is not producing in paying quantities, the lessors might not receive all of their interests. The production in paying quantities rule certainly provides the most protections to the lessors, however the Kentucky rule also ensures that they will receive their benefits stemming from other interests. While lessors might not receive as much in royalty payments, the operator must be able to pay at least some amount in royalties in order to keep the lease. Similarly, if the lessee is able to pay royalty payments, then it means that enough oil or gas is being produced that the lessor might be able to receive some additional benefits, such as free gas. At the same time, the operator's burden has decreased, giving them more time to achieve a higher output from the well.

3. Lessee Interest Protection

First and foremost, the lessee has the goal of making a profit. To achieve this goal, the company must not only produce enough oil so that their revenues cover lifting costs but covers the total expenses of the company. However, a large concern for each company is competition. Due to this concern, it would benefit the company to hold a lease on oil-and-gas-rich land for the sole purpose of keeping their competition from developing the land. The lessee might not have an interest in developing the land anytime soon, or even at all. Preventing competing companies from accessing the land could be worth only holding the land for the primary term. While this might be important to the lessee, it is in direct conflict with the interests of the lessor and the public. However, the interest in producing oil and gas at a profit is not in direct conflict. To do this, it takes time. So, the lessee's interest must also be protected so that the lease is not terminated prematurely.

The best approach for protecting the lessee while harmonizing with both the publics and the lessor's interest is to define production following Kentucky's view. This method takes into account that many leases have marginal or sporadic wells and does not punish a lessee for such luck. However, it does require a minimum amount of production from the operator in order to satisfy that lessor. The only issue that this minimum effort production can continue for an indefinite period of time.

E. Striking a Balance

In order to protect the interests of each of the three parties, a fine line must be walked. To achieve such a great feat, the three views of Oklahoma, West Virginia, and Kentucky must be combined and modified. To satisfy production in the habendum clause, the courts should follow the Kentucky method while determining a minimum barrel amount per quarter. For periods that do not meet production standards, there should be a two-step inquiry. Step one would follow the West Virginia methodology. Step two would be the same subjective test that is currently used by Oklahoma.

1. Production Defined

The Kentucky view of production is that there has been enough oil or gas produced to pay a royalty to the lessor.[205] This view protects the lessee's interests by not placing a large burden of production on the operator, but just a small minimum. It also protects the lessee by providing a guarantee of royalty payments. However, it does not satisfy the public's interest in ensuring that there is enough oil in the market to meet consumer demands.

An additional step is necessary to address the public's needs. Each quarter, a lease would be required to have produced a minimum amount of oil or gas. This amount would be determined by the court. The court should look at the average amount of oil or gas taken from the region, the formation being drilled, and the average production of operators of similar means. From the average produced, then the minimum amount should be determined as more than what is needed to pay a royalty, but less than production in paying quantities. This would ensure that a substantial amount of oil or gas is being produced, thus satisfying the lessor and the public, but does not overly burden the operator. The goal of this minimum is to create a production amount that is higher than Kentucky's tangible and substantial requirement but lower than Oklahoma's paying quantities requirement.[206]

When determining the minimum quarterly amount, the drilling region should be analyzed because geological differences affect the lifting of oil and gas. For example, the porosity of the earth in a particular region can affect the drilling of oil and gas.[207] The formation that is being drilled should be considered in combination with the region because each deposit of oil or gas will have a different reservoir pressure. If the pressure is low, it can cause the amounts of oil and gas being drilled in that area to be lower. Pressure that is too high can make a drill site dangerous causing slow operations.[208] With each case, the comparison should weigh operators of similar means and size. This is because it would be unequitable to hold a small operation to the same standard as a large corporate operation.

205. *See Enfield v. Woods*, 198 Ky. 328, 329-30 (Ky. 1923).
206. *See Enfield v. Woods*, 198 Ky. 328, 330 (Ky. 1923).
207. *See generally,* John S. Lowe Et Al., Cases and Materials on Oil and Gas Law 15-16, (Thomson West, 7th ed. 2018).
208. *See generally, id.* at 16-18.

By applying the above three factors into a minimum standard, it combines both objective values and subjective values. The region's geological composition is objective and affects each drilling rig in that area. The formation's reservoir pressure similarly affects all operations in the region that are tapping into the same reservoir. However, by only comparing operators to those in a similar position, it adds a subjective value to the analysis. These considerations protect both the lessee and the lessor. The lessee is protected because the court will take factors outside of their control into consideration. The lessor is protected because their contract will not be terminated simply because a small-business lessee is not able to produce at the same level as a large corporation. By avoiding this risk, the lessor's interests in payments are protected while simultaneously providing protection to small businesses.

2. Periods in which Production Lapses

The production of oil and gas, while well researched, can be unpredictable at times. Equipment can stop working and need repairs, or even to be replaced. The pressure of the reservoir may suddenly drop. Or, as many contracts provide for in express language, there can be "acts of God," like extreme flooding which prevents operations by making the well inaccessible for an unknown period of time. In any of those events, as well as many others, the lessee needs protections. For periods outside of the primary term during which production as defined in the previous section ceases, a two-step analysis will be applied by the court.

The first step of the two-step analysis is to ask the question "Has there been a showing of oil and gas on the leased property?" This question is taken directly from the West Virginia methodology. By asking this question, the spirit of the purpose behind the lease is honored.[209] However, the amount of oil that has been shown to be present on the property must be enough to justify the continuation of the lease, which ties directly into step two. In the event that there is not a showing of *any* oil or gas on the property, the analysis ends at the first step, and the lease is terminated.

The second step of the analysis is Oklahoma's subjective test with a minor adjustment. This test would still turn on an operator's good faith intentions, just as it does in Oklahoma.[210] The standard in this analysis would be whether under all the relevant circumstances and the amount of

209. *See South Penn. Oil Co. v. Snodgrass*, 71 W. Va. 438, 451 (W. Va. 1912).
210. *See* 2 Eugene Kuntz, A Treatise on the Law of Oil and Gas § 26.7(e) (Matthew Bender, Rev. Ed.).

oil and gas shown present on the leased property, a reasonable and prudent operator would "continue to operate a well in the manner in which the well in question was operated."[211]

Step one protects the lessor and the lessee. The lessor is protected because the lease terminates in the event that there is no showing of oil or gas present on the property. This allows the lessor to gain their property rights back without the intrusion of the operating company on their land, or it allows the lessor to seek a new oil and gas lease from another company that may find oil and gas on the property at a different depth. The lessee is also protected in this event, as they would no longer need to pay to operate on the leased premises or pay delay rentals. The lessee is protected in the opposite event as well. If there is a showing that oil and gas is present on the leased property, then the lease is protected subject to the second step of the analysis. If the operator acts diligently, prudently, and in good faith, then he need not be wary of step two.

The second step of the analysis protects all three parties of interest: the lessor, the lessee, and the general public. The lessor is protected in two ways. The first is similar to the protection provided by the first step. If the operator is not acting in a prudent way, then the lease is terminated. When this happens, the lessor can go find a different operator who will operate the well with diligence and good faith intentions. The second way the lessor is protected is that if the lessee is operating the well as he should, the lessor's lease is not cancelled. This gives him stability with regards to his rights, as well as the possibility of future royalty payments. The lessee is protected because the lease is not canceled simply because there is no production. As long as the lessee is operating as he should, his lease is not in jeopardy. Lastly, the general public's interest in the production of oil and gas is protected. Its interest is protected similarly to the first way the lessor is protected. If the lease is not being handled properly, then someone else can come in and produce oil and gas prudently. Second, its interests are protected because this step of the analysis ensures that an operator is actively working towards producing oil and gas to provide it to the consumer market.

V. Conclusion

Production in Oklahoma does not just mean production. It really means production in paying quantities. However, this definition does not lend itself to a legal analysis that provides consistent results. Neither does it

211. *See Clifton v. Koontz*, 160 Tex. 82, 89 (Tex. 1959).

provide many protections to parties other than the operator. While other states utilize other definitions and other legal analyses, they still fall short.

The best way to protect the lessor, lessee, and the public is to apply a hybrid approach when interpreting production in the oil and gas lease. This method requires only enough oil and gas to pay a royalty to the lessor while simultaneously meeting a minimum barrel requirement. In the event that the lessee is not satisfying production as so defined, then the courts will apply a two-step analysis in order to determine if the lease should be terminated. First, the court should ask if there has been a showing of oil or gas on the property. If not, then the lease is terminated. If so, then the court should move on to step two. Step two applies a subjective test to the operator. This step asks if a reasonably prudent operator would continue to operate a well under the same circumstance and in the same way as the lessee. If the answer is no, then the lease is terminated. If the answer is yes, then they lease may continue. This approach creates clear guidelines for operators to follow and makes the guidelines simple for the lessee to understand. This approach also protects the public's interest in the production of energy materials. Similarly, this approach creates consistent results in the court system.

Ultimately no analysis, system, or definition will be perfect. To avoid the headache altogether, provide explicit language within each oil and gas lease. If all terms are defined in a clear manner, then the court does not need to supply its own definitions. Similarly, provide clear meanings for savings clauses. With a clear meaning and application laid out in the lease, the court only needs to look to the four corners of the document and apply the lease as it was written.