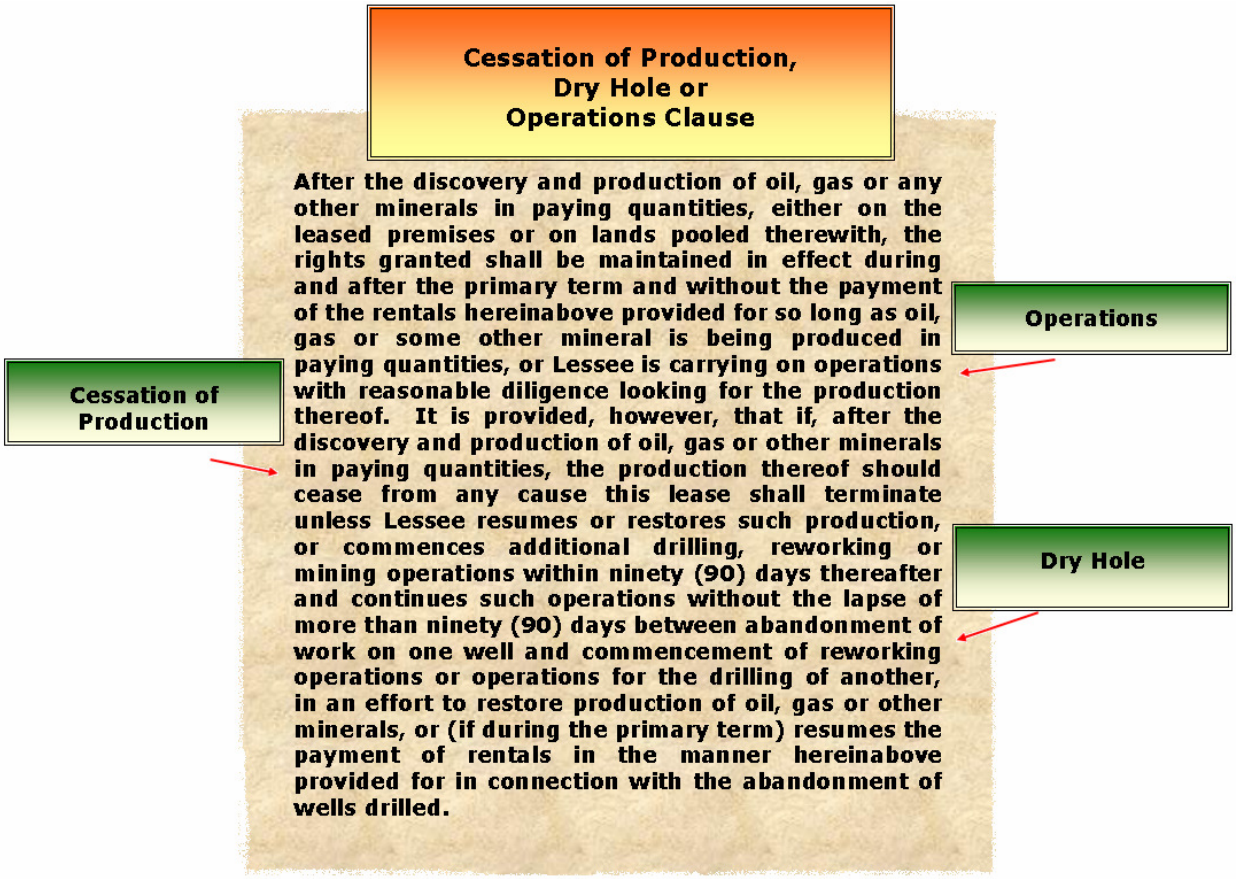
Chapter 7

The Termination Clauses of The Lease:

The Cessation of Production Clause

CESSATION OF PRODUCTION, DRY HOLE OR OPERATIONS CLAUSE

The second way a lease would terminate during the secondary term is when cessation of production occurs. This might be the result of mechanical problems, production problems or simply that the well is no longer capable of producing in paying quantities. The cessation of production might be temporary or it might be permanent. In either case, language in the lease would generally provide for non-termination of the lease in case of cessation of production.



In many cases, the lease has not lost its value simply because of a temporary cessation of production and the lessee would want an opportunity to correct whatever problems exist in order to save the lease. The language as shown in the example provides for such an opportunity.

THE DOCTRINE OF TEMPORARY CESSATION OF PRODUCTION

Prior to adding this clause to the lease, the *doctrine of temporary cessation* was developed. Generally, this doctrine holds that if a lease does not contain cessation of production language and if a temporary cessation of production occurs due to mechanical problems, the lease will not terminate if diligent and reasonable efforts are made to restore production.[1]

The term "temporary" is vague in nature; however, it is important to note that a well cannot experience *temporary* cessation unless it first experiences *actual* production in paying quantities.

DETERMINING PERMANENT V. TEMPORARY CESSATION

In an attempt to determine whether the cessation of a well is permanent or temporary, a court will often attempt to answer three questions. They are:

1. What is the length of time the lease has failed to produce in paying quantities?

   There are many reasons a well might cease to produce in paying quantities and each of the reasons might impact this length of time differently. For instance, the time it would take to repair a casing leak would be different than the time it would take to clean out silt deposits clogging the well tubing. Also, the response of the operator could impact this length of time and would be taken into consideration by the courts.[2]

2. What is the cause of the cessation of production?

   The answer to this question most often determines whether the cessation is permanent or temporary. In other words, if the reserves have been depleted and there is no oil or gas left to produce, the cessation is permanent. If cessation is caused from a casing leak and the operator is attempting to repair the casing, the cessation is temporary.[3]

3. What was the lessee's response when operations were discontinued?

   The *immediate actions* of the operator seem to speak very loudly to courts. A judge hearing testimony about *immediate* and *persistent actions* on the part of one operator might respond more favorably than if the same judge heard only testimony about the *plans* and *intent* of another operator.[4]

States have varied a great deal in their attempt to determine what a *temporary* length of time constitutes. The Arkansas Supreme Court in *Saulsberry v. Siegel* held that cessation of production, as a result of a

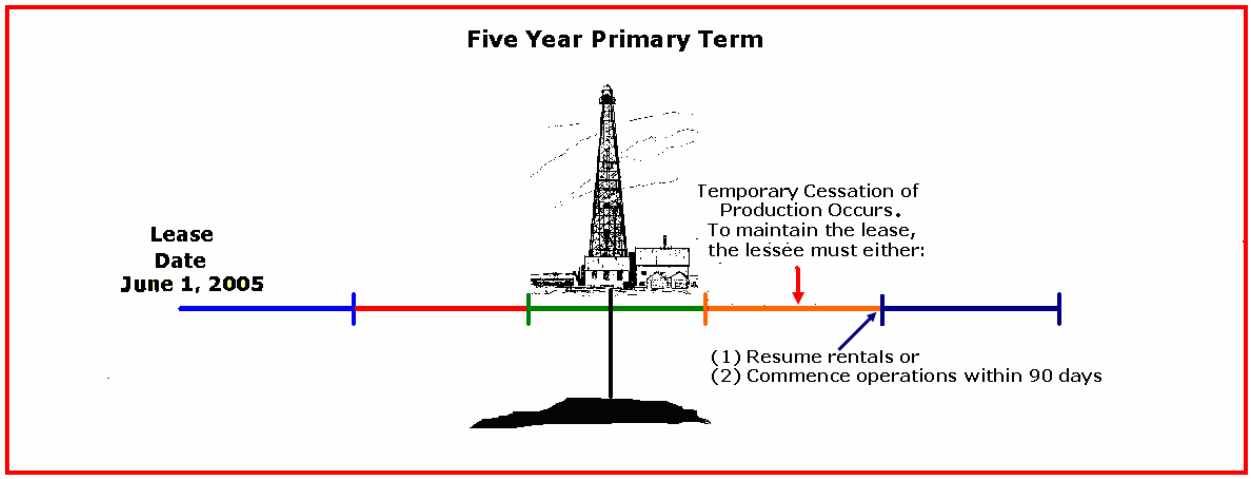
fire, was indeed temporary even though the production had ceased for 4 years. It appears that this Arkansas court felt that the cause of the cessation and the length of time to correct the problem justified temporary cessation.

In *Wagner v. Smith*, an Ohio court ruled that a well which had ceased to produce for 3 years, because of water in the borehole, did not meet the *temporary* definition and had ceased to produce permanently.[5] It appears that the Ohio court felt that the cause of the problem and the operator's failed attempts to correct the problem justified permanent cessation.

Regardless of these two cases, once cessation has occurred, the lessee has only a reasonable amount of time in order to return the production back to paying quantities. "*Paying Quantities*" is the benchmark for the establishment of returning the well back to production.

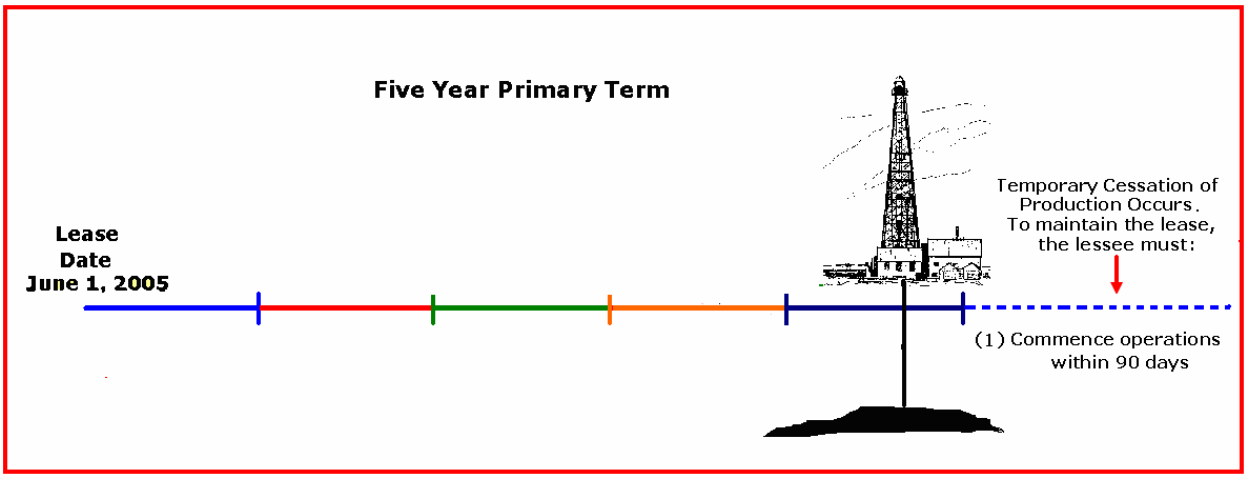
CESSATION OF PRODUCTION

If a well experienced cessation of production during the *primary* term, the lease would not be in jeopardy of termination. In such a case, either a rental payment; a shut-in payment, where appropriate or operations would hold the lease during the current annual period.



On the other hand, if cessation of production occurred during the secondary term, the lessee would be dealing with another set of rules. In this case, the lease could only be held if additional drilling operations or reworking operations commenced during the time frame as set out in the clause. If it were determined that the cessation of production was permanent and no other wells were going to be drilled, the lease would automatically

terminate. In a case where the well could not be returned to the paying quantities benchmark, the lease would also terminate.



WHAT CONSTITUTES OPERATIONS?

In order to avoid a court's definition of *temporary*, most oil and gas leases contain language in the cessation of production clause that will allow the lease to continue in force and effect as long as the lessee has:

1. Restored production
2. Commenced reworking operations
3. Commenced additional drilling operations or
4. Continuous drilling is occurring

If ... production thereof should cease from any cause this lease shall terminate unless Lessee resumes or restores such production, or commences additional drilling, reworking or mining operation within ninety (90) days thereafter...

Generally, the lease will establish a set number of days whereby corrective operations must begin – sixty or ninety days. In a case where the length of time is established (as in the example language) and corrective operations have not begun within ninety days, the lease will terminate.

COMMENCING REWORKING OPERATIONS

If your company owned a lease where production had ceased, your first option would be to set in motion corrective operations to restore the well back to paying quantities.

There exists, in the United States today, many older oil and gas fields that are often characterized by low production, dwindling reserves or outdated and damaged equipment. Clearly, to disregard these fields or these wells as non-valuable would be a mistake. When effective corrective measures can be taken, companies often increase production from these fields. This type of procedure happens all the time. These corrective measures are often referred to as a well workover or reworking the well.

The Schlumberger Oilfield Glossary defines a well workover and intervention in the following manner:

> "The process of performing major maintenance or remedial treatments on an oil or gas well. In many cases, workover implies the removal and replacement of the production tubing string after the well has been killed and a workover rig has been placed on location. Through-tubing workover operations…are routinely conducted to complete treatments or well service activities that avoid a full workover where the tubing is removed. This operation saves considerable time and expense.[6]

In many cases, restoring a well might only require cleaning out deposits of sand or silt that have clogged the well tubing. This type of maintenance work might be referred to as a reworking of the well.

COMMENCING ADDITIONAL DRILLING OPERATIONS

If your company owned a lease where production from the well had ceased and it was determined that no corrective operations could restore the well back to current production, would the lease be lost?

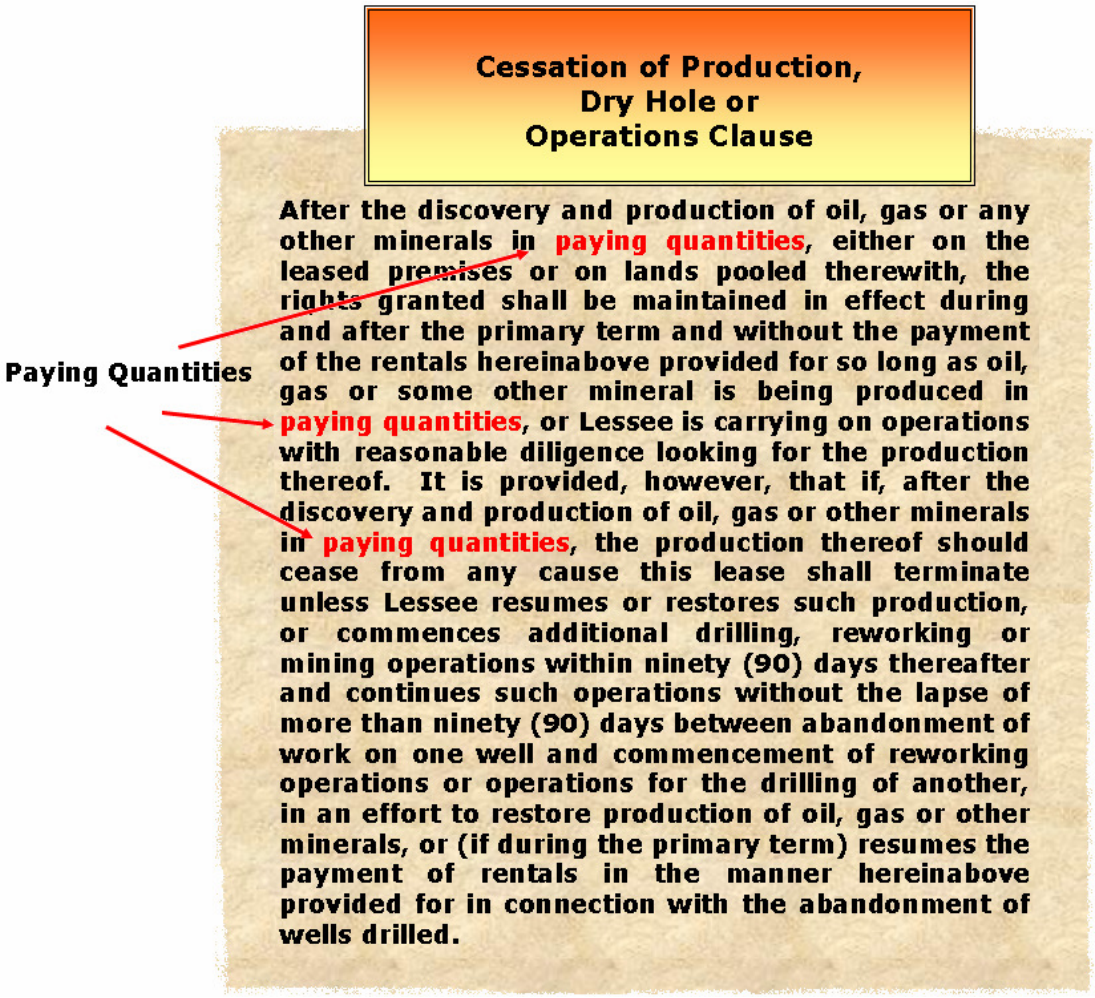
In this case and according to the language in the clause, the only recourse available for your company is to begin drilling an additional well. This must occur within the time frame as set out in the lease clause. If this is done, the lease is saved.

If the drilling of this second well turned out to be dry hole, would the lease be lost?

According to the language in the clause, your company would have ninety days from the abandonment of work on the one well to the commencement of work on the additional well. If this is done, the lease is saved.

DRY HOLE OR CONTINUOUS DRILLING

Many places within the body of the lease contain the term *paying quantities.* This term has become the benchmark for determining a legitimate oil or gas well. A well that does not produce in paying quantities is not considered a legitimate well. *Paying quantities* appears three times in the Cessation of Production, Dry Hole or Operations Clause.



In light of this, a dry hole can occur when either no reserves are found or when the reserves found are not significant enough to produce the well in paying or commercial quantities.

When this happens, a company is faced with the choice of letting the lease go or drilling another well. According to the terms in the example language,

additional wells must begin within ninety days from the abandonment of one well and the commencement of another well.

Dry holes can be very expensive as seen in the following internet article taken from Green Car Congress, an organization established to report on energy, technologies, issue and policies. As you read the article notice that the well cost a record 100 million dollars to drill but was determined to be a dry hole because the reserves found were not significant enough to qualify as *commercial* deposits.

A Very Disappointing Dry Hole

4 October 2004

ExxonMobil has shut down the first offshore ultradeep well in the Zafar-Marshal field off of Azerbaijan after failing to find commercial deposits - in other words, it was a dry hole.

"We discovered that the first well on Zafar-Marshal does not contain commercial hydrocarbon reserves and we decided to shut it down," Exxon's spokeswoman Leila Rzakuliyeva told Reuters.

"It's premature to talk about drilling new wells on the field," she added.

At 7,087 meters, the well was the deepest in the Caspian and Azeri region. Geologists have said it was the most expensive too, costing Exxon more than 100 million.

Exxon's spokeswoman said, "It's premature to talk about drilling new wells on the field." If this were your lease with a ninety day continuous drilling clause and the lease had passed its primary term - what would happen to the lease if a second well was not commenced within the ninety days? The answer is simple. The lease would terminate.

In an attempt to more fully understand this portion of the lease language, answer the following questions:

1. Your company owns a lease which states that if production stops, you have 60 days in which to "commence operations to restore production or to drill another well". For the last 90 days your company has been trying to restore production. Has the lease terminated because production was not restored within the 60 days?

   _____

   _____

   (Answer: No. The time frame references only the number of days required to begin corrective operations. The important words in the clause are "commence operations." If your company has commenced operations within the 60 day period, they can continue their rework for as long as is reasonable to restore production, if they are attempting to do so in a prudent and diligent manner.).

2. Your company has drilled two producing wells on a lease. Last month one of those wells ceased to produce. The lease provides that if production stops; you have 90 days in which to restore production or to drill another well. Sixty additional days lapsed before your company began rework on the well. Has your lease terminated?

   _____

   _____

   (Answer: No. The lease is still held by the production of the producing well. In a case like this, your company does not have to begin operations within the ninety day time frame. The ninety day time clock would only begin ticking if both wells went down.)

3. Your company drilled a well on a lease that produced a gas well but only in minimal amounts of gas. Your company's plan was to drill other wells in the unit in hopes of locating better gas reserves but they did not consider the first well economic to produce. Ninety-five days after the primary term of the lease your company sent a field man to stake a second location. At that time an argument broke out between the lessor and your field man. The lessor insisted that the lease had terminated. Your field man kept pointing to the well that was producing minimal amounts of gas. Who was correct?

_____

_____

(Answer: The Lessor. The first well drilled did not meet the "Paying Quantities" benchmark. Even your company did not consider this well as a well economic to produce; therefore, the lease expired on the expiration date of the primary term.)

Footnotes:

[1]South Texas College of Law, Student Bar Association, Oil and Gas Outline, Professor Strausser, 2004 www.stcl.edu/students/sba/outlines.

[2]An Introduction to Kansas Oil & Gas Law, David E. Pierce, University School of Law,1988.

[3]Ibid.

[4]Ibid.

[5]South Texas College of Law, Student Bar Association, Oil and Gas Outline, Professor Strausser, 2004 www.stcl.edu/students/sba/outlines.

[6]Schlumberger Oilfield Glossary, www.glossary.oilfield.slb.com.