



## Chapter 8

# The Termination Clauses of The Lease: The Shut-in Royalty Clause

# SHUT-IN CLAUSE

Failing to properly make a shut-in royalty payment is another way that the oil and gas lease can terminate during the secondary term of the oil and gas lease.

As stated in the following language, a shut-in payment can be made during either the primary or secondary term of the lease. Such a payment made during the primary term will take the place of any rental payment that is due. A lessee would not send the lessor both a rental payment and a shut-in payment for the same period of time.

This payment will also relieve the lessee from having to conduct actual operations during either the primary or secondary term.

## Shut-in Clause

**During any period (whether before or after expiration of the primary term hereof) when gas from any well or wells on the premises capable of producing gas in commercial quantities is not sold or used and the well or wells are shut in and there is no current production of oil or operations on said leased premises sufficient to keep this lease in force, lessee shall pay or tender a royalty of One Dollar (\$1.00) per year per net royalty acre retained hereunder, such payment or tender to be made, on or before the anniversary date of this lease next ensuing after the expiration of ninety (90) days from the date such well is shut in and thereafter on the anniversary date of this lease during the period such well is shut in, to the royalty owners. When such payment or tender is made it will be considered that gas is being produced within the meaning of the entire lease.**

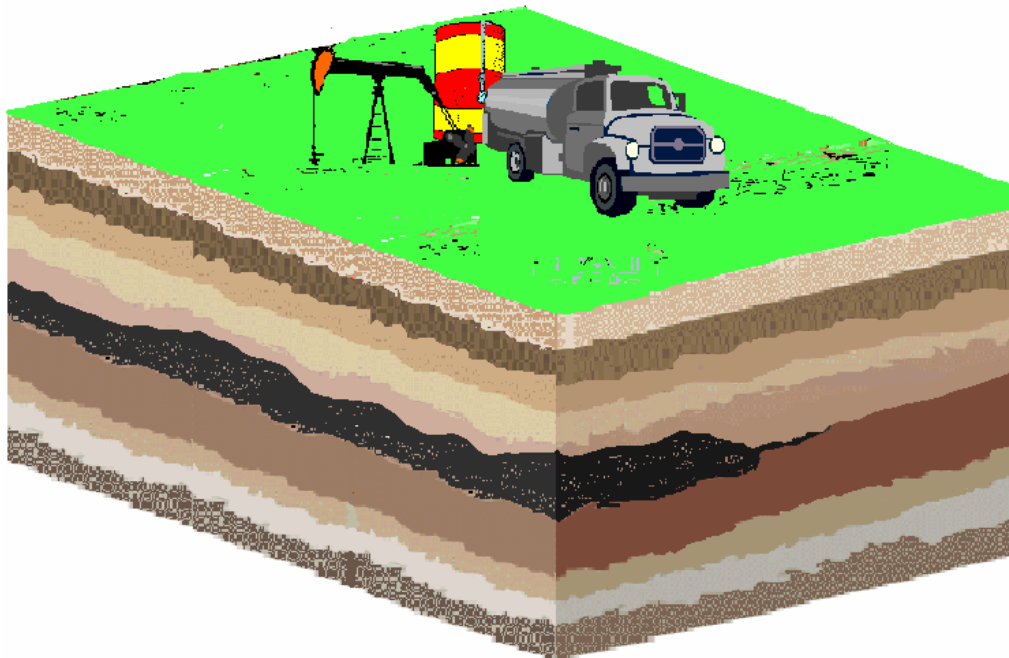
## PURPOSE OF THE SHUT-IN CLAUSE

In order to understand the purpose of the shut-in clause one should travel back in time. The oil boom came about as a result of the invention of the automobile. Because the gasoline that powered this invention came from the oil in a producing well and not from natural gas, the natural gas was originally not considered as valuable. Many companies just did not produce the gas. In some cases, gas was flared and thus lost forever. Once the tremendous value of natural gas was realized, oil companies began to

explore for and develop natural gas fields. In doing so, there was a unique problem that existed - that being, transporting the gas to the marketplace.

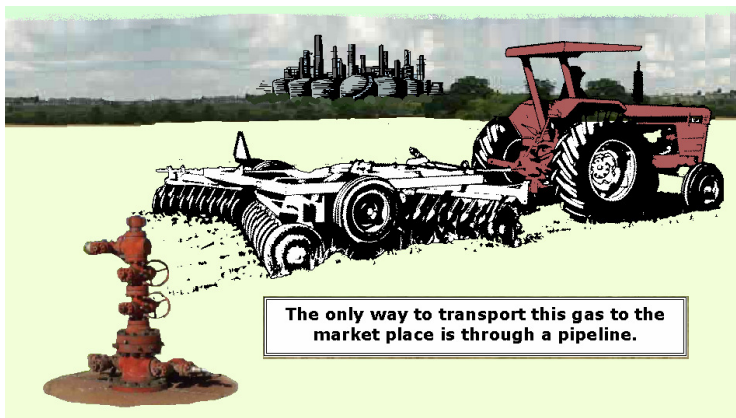
It was this problem that gave way to the "shut-in royalty clause" as we know it today.

Transporting oil to the market place was an easy matter. Oil is found in a liquid state. It could be pumped out of the ground and placed into tanks. A truck would back up to the tank, unload the oil and then drive it to the marketplace.



**Getting oil to the marketplace is an easy matter.**

Because gas is not in a liquid state, rather a gaseous state, it could not be pumped out of the ground and placed into some sort of tank. The only way to transport this gas to the marketplace was through a pipeline.



When companies first began to see the value in natural gas, there were no pipelines. Although there are numerous pipelines in existence today, when a company first completes a

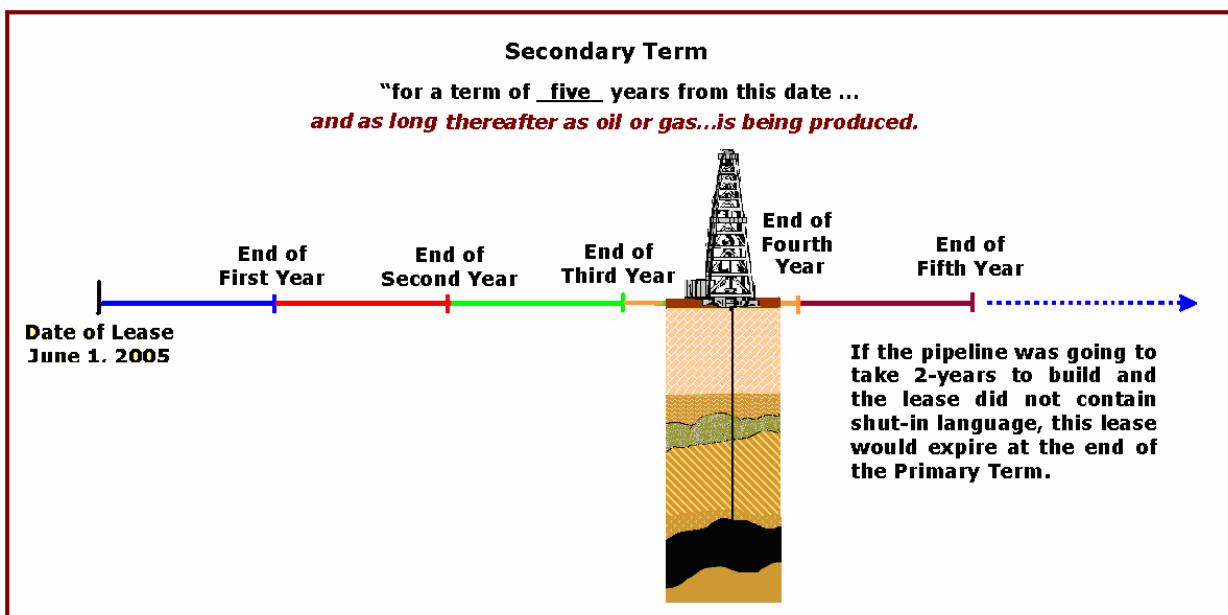
well, the line needed to flow the gas from the wellhead and into the pipeline does not exist. Building that line takes time.

Remember the Habendum Clause? The lease clearly states that at the expiration date of the primary term, *the lease will automatically terminate unless there is actual production from a well*. Having a well *capable* of production and having *actual production* are two different matters. This language became the bigger part of the issue facing oil companies. They might have drilled the well and reached a very productive natural gas zone capable of producing millions of dollars in revenue; however, if no pipeline existed in the area or there were not refineries in which to handle the gas, the well would not be capable of *actual production*.

Let's say the pipeline was going to take two years to build and the primary term on the lease was going to expire in 12 months. Without the shut-in provision the oil company was up the creek without a paddle. Their lease would terminate.

## WHEN CAN A WELL BE SHUT-IN?

The shut-in royalty clause was established to protect the lessee against loss of the lease when production became either impossible or unadvisable. In cases like this, the shut-in royalty provides for a payment to be made to the lessor as a substitute for any *actual payment out of production*. The payment can be made either during or after the primary term and in cases where the payment is made during the primary term, such payment is made in lieu of any delay rental that is due.



This clause gives the lessee the right to *temporarily* stop the production of gas from a well. This temporary non-production is limited in its scope, however. Clearly the lessee is protected if transporting gas is impossible because of the pipeline issue as discussed. Production can also be shut-in for what is referred to as "a lack of a market". This term has been defined by the courts in two ways:

1. Is there no market available for the gas? In other words, the purchaser of the gas does not have either the ability to or capacity to buy any more of the gas capable of being produced. Thus, the well must be shut-in.
2. Is there simply a lack of a reasonable market for the gas? In other words, the purchaser has the ability to transport the gas and refine the gas but they are offering to pay unreasonable prices for the gas.

In a case like this, can a company shut the gas in until the price becomes more economic or until they find a better price for the gas? It is this question that involved the courts and different courts answered the question differently. Oklahoma courts have said, "Yes." A lessee can, in fact, shut a well in if they are trying to find a more marketable price for gas. Kansas courts have said, "No."

The important issue here is that a lessee may be at risk of losing an important lease, if the reason for shutting the well in was determined to be illegitimate. Even in Oklahoma, a company would be at risk of losing the lease, if the well had been shut-in seven years because they could not find a better price for the gas. Such reasoning would most likely be considered illegitimate.

Keep in mind that losing the lease, in this case, is about much more than just losing a piece of paper called an Oil and Gas Lease. In this case, the well, the expense of drilling the well and the potential revenue from the well is also lost.

## **SHUT-IN OBLIGATIONS**

### **WHEN IS THE PAYMENT DUE?**

Today's leases contain a variety of language establishing the payment due date and the amount due. Normally, if the well or wells have been shut-in prior to the end of the primary term, the payment is due 60 or 90 days after the end of the primary term. If the well or wells have all been shut-in during the secondary term, the payment is due 60 or 90 days after the shut-in has taken place and then on the anniversary date of the lease. To assume that the obligation in one lease is the same as the obligation in another lease would be wrong.

### **LANGUAGE LIMITING THE LENGTH OF TIME FOR A SHUT-IN**

Often a lessor will add language limiting the length of time that a well or wells can be shut-in. Such language might read:

*"After the end of the primary term, this lease may not be maintained in force solely by reason of the shut-in royalty payments, as provided heretofore, for any one shut-in period of more than three (3) years, or, from time to time, for shorter periods which exceed three (3) cumulative years."*

or "no more than two years beyond the end of the primary term or two years in the aggregate."

Once the time limit obligation has been met on such a lease, unless there is actual production in paying quantities, the lease will terminate.

### **THE AMOUNT DUE FOR A SHUT-IN PAYMENT**

Traditionally, the shut-in amount due is \$1 per year, per net mineral acre owned by the lessor. However, today's leases can contain a variety of dollar amounts. If the payment is based on \$1 per net acre owned and the lessor owned a undivided 25% mineral interest in a lease covering 160 acres, the shut-in payment would be  $160 \times 25\% \times \$1.00 = \$40.00$ . Some state leases require a shut-in payment of \$1,600 per year per well. In a case like this, the payment is not based on net acres owned, rather on wells drilled.

## **CORRECT PAYMENT TO THE CORRECT OWNERS**

A Texas court established that shut-in payments must not only be made on time and in the correct amount but must also be made to the correct parties. In order to problem solve this issue; many newer leases contain language that allows the lessee to make one payment to the lessor.

Example:

In the following example, unless the lease allows you to make only one payment to Dennis Bright, the lessor, the shut-in payment should have been made to:

Dennis Bright \$80  
Donald Bright \$80

1.



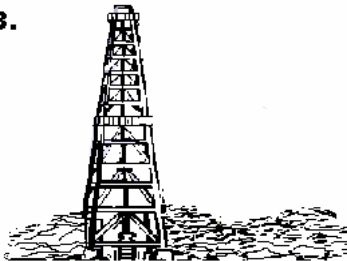
**Your company acquired a 160-acre net mineral lease from Dennis Bright.**

2.



**Dennis sold 50% of his minerals to his brother Donald Bright. A copy of this conveyance was sent to your company.**

3.



**Your company drilled a well but have shut this well in waiting on a pipeline connection.**

4.

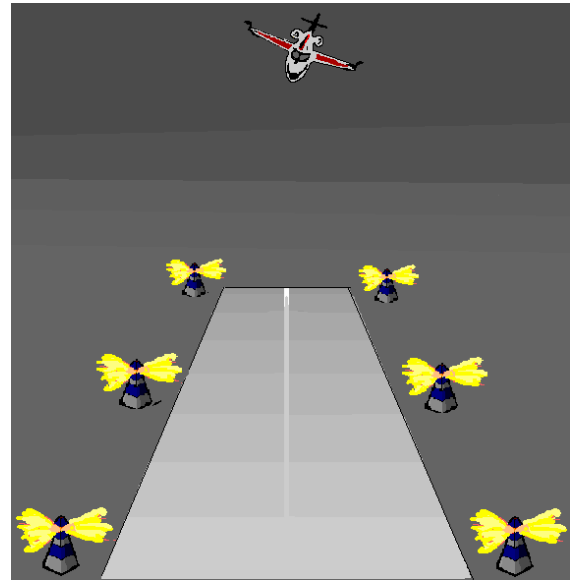


**90 days after the end of the primary term your company sent a shut-in payment check of \$160 to Dennis Bright**

Shut-in payments must not only be made on time and in the correct amount, but must also be made to the correct parties. Since your company received notice of the transfer of interest, paying only Dennis could have placed the lease in jeopardy.

## THE THREE BEACONS OF THE SHUT-IN CLAUSE

Picture an airplane attempting to make a landing in the dead of night. The pilot would definitely be looking for the runway but more importantly he would be making sure that the beacon lights were lined up. If the lights were in a straight line, the pilot could fly his plane in the same straight line landing on the runway. In the same way, the shut-in clause contains three beacons that must be turned on and



in a straight line if a shut-in payment is to be made. If only one or two of the three beacons are turned on then no shut-in payment should be made to the lessor. Those three beacons are as follows:

1. Is there a gas well or wells capable of producing in commercial quantity but the gas is not being sold and the wells are shut-in?
2. Is there no current production of oil?
3. Are there no operations on the leased?

If the answer to each of questions is, "yes" then the three beacons are turned on and a shut-in payment should be made. If the answer to one of these three questions is "no", then the shut-in payment should not be made.

### 3 Beacons of the Shut-in Clause

**During any period (whether before or after expiration of the primary term hereof) 1. when gas from any well or wells on the premises capable of producing gas in commercial quantities is not sold or used and the well or wells are shut in and 2. there is no current production of oil or 3. operations on said leased premises sufficient to keep this lease in force, lessee shall pay or tender a royalty of ...**

### EXAMPLE 1:

Your company acquired a 3-year lease dated January 25, 2002. In March of 2004, your company drilled a productive well that produced both oil and gas. Since that date, no other operations have been in place on the lease or lands pooled with the lease.

Nine months ago, the price of gas dropped to an all time low, far below your company's ability to make money. Management decided not to produce the gas until the price rose to an economic level; however, no shut-in payment was sent to the lessor.

Last week the lessor sent a certified letter, to your attention, contending that the lease had been terminated because no shut-in payment had been received.

*In order to keep this lease active, should your company have made a shut-in payment to the lessor?*

**(Answer)** Remember the three beacons. In this case, were all three of the beacons turned on?

- Was there a well or wells capable of producing in commercial quantities but the gas was not being sold and the well or wells were shut-in? Yes, there was a well that met that standard.
- Were there no operations on the leased premises? Yes, there were no operations.
- Was there no current production of oil? No, there was oil production. In the example, the well produced both oil and gas.

In this case, only two of the three beacons were turned on, so no shut-in payment should have been made.

### EXAMPLE 2:

Your company drilled and is producing two gas wells on a particular lease. The lease is now in its secondary term. Your company decided to drill a third well. This well was recently completed but because of an inability to connect a pipeline, this well was shut-in. The lease requires a shut-in payment within ninety days of the shut-in. Should you make such a payment to the lessor?

**(Answer)** Remember the three beacons. In this case, were all three of the beacons turned on?

- Were there no operations on the leased premises? Yes, there were no operations.
- Was there no current production of oil? Yes, there was no current production of oil.
- Was there a well or wells capable of producing in commercial quantity but the gas was not being sold and the well or wells were shut-in? No, there were three wells capable of producing in paying quantities, two of which are *not* shut-in. They are producing gas; therefore the lessee is not liable to make a shut-in payment on the one well which was shut-in.

In this case, only two of the three beacons were turned on so no shut-in payment should have been made.

## GENERAL RULES SURROUNDING THE SHUT-IN CLAUSE

- A. Traditionally, the shut-in payment is limited to gas and unless the lease specifically states otherwise a shut-in payment can not be made on oil wells.
- B. The well being shut-in must be capable of producing gas in paying quantities.
- C. Failure to make the proper shut-in payment when the payment is justified will result in the termination of the lease.
- D. If the shut-in clause does not specify the time that the shut-in payment is due, the payment is due before the well is shut-in.

### General Rules for the Shut-in Clause

**During any period (whether before or after expiration of the primary term hereof) A. when gas from any well or wells on the premises B. capable of producing gas in commercial quantities is not sold or used and the well or wells are shut in and there is no current production of oil or operations on said leased premises sufficient to keep this lease in force, C. lessee shall pay or tender a royalty of One Dollar (\$1.00) per year per net royalty acre retained hereunder, such payment or tender to be made, D. on or before the anniversary date of this lease next ensuing after the expiration of ninety (90) days from the date such well is shut in and thereafter on the anniversary date of this lease**

## SHUT-IN IS GENERALLY LIMITED TO GAS

Item *A* above limits the shut-in to *gas*. The lease says, “when gas from any well or wells ... is not being sold ... and the well or wells are shut-in”. In *Collins v. Oil & Gas Co*, 85 Kan. 483, 487-89, 118 P. 54, 56 (1911) the Kansas court ruled that an oil and gas lease terminated even though the oil company had drilled five *oil* wells.<sup>2</sup> These wells were capable of producing in paying quantities but because of the low price of oil, the company chose not to produce the wells. Instead they made shut-in payments. The asset lost in this case was much more than just a single piece of paper. It was five drilled and completed wells capable of producing in paying quantities.

## HOW IS PAYING QUANTITIES DETERMINED?

Item *B* above states that a shut-in well must be capable of producing gas in commercial (paying) quantities. This term becomes a very important term in understanding issues surrounding a legitimate well and appears numerous times throughout the lease.

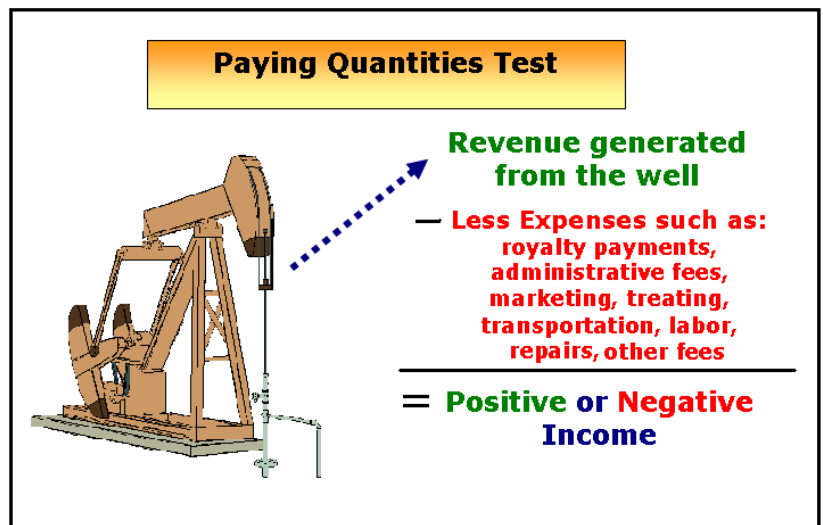
Just because a company drills a well does not mean that the company has established an official well. The litmus test in determining whether a well is legitimate is the *paying quantities test*. Does the well produce in paying or commercial quantities?

The following formula is a simplified version of what this test looks like:

In this example, if the outcome is negative income, the well does not meet the paying quantities test. If the outcome is positive income, the well does meet the paying quantities test.

Notice that the expenses that would be deducted from the revenue include royalty payments but do not include overriding royalty payments. Drilling and/or reworking costs are also excluded.

A recent court case in Arkansas, *Ross Explorations, Inc. vs. Freedom Energy, Inc.*, 340 Ark. 74, 8 S.W.3d 511 (2000), determined that paying quantities was

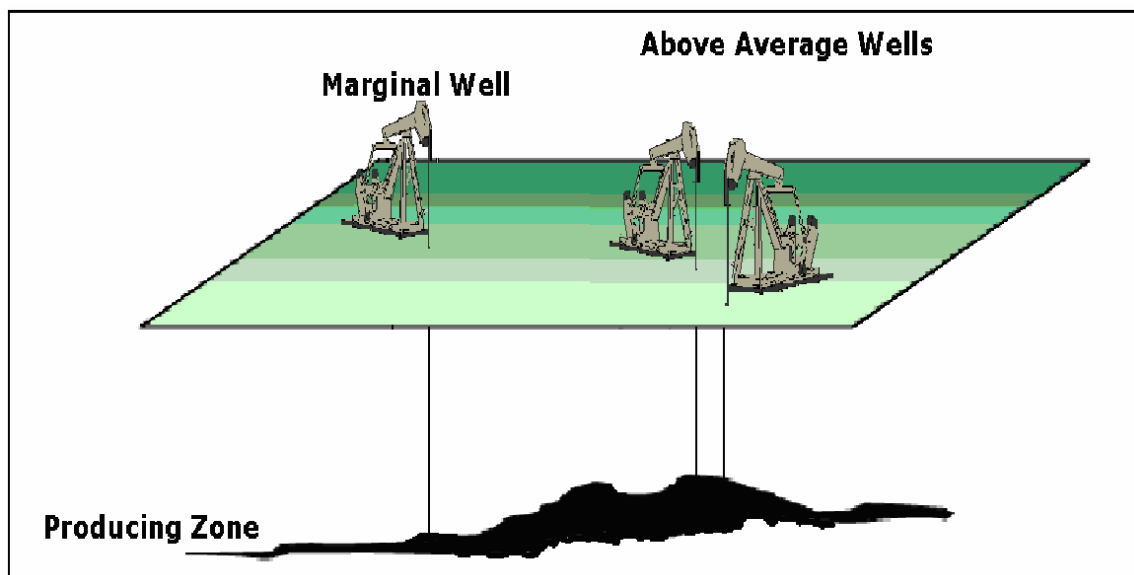


established if the well created a profit, "however small" and determined that the following expenses could be attributable to the operation of the lease:

1. pumping labor
2. field labor
3. auto/truck
4. road/location
5. chemical treating
6. taxes
7. salt water disposal
8. product/equipment services
9. well services
10. services for leased equipment and other and indirect services
11. materials and supplies.<sup>3</sup>

When determining paying quantities, two questions arise. First, what is the appropriate length of time used to calculate either positive or negative income? In other words, a very marginal well may have been producing in paying quantities for the last six months but failed to meet the test during the last month. Does such a well fail the litmus test? In such a case the answer would be no. Courts, however, have been inconsistent in establishing a standard length of time. Instead, they have attempted to decide whether a "reasonable prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate the well or wells situated on the lease."<sup>4</sup>

The second question generated as one evaluates this litmus test is: Does the test apply to an individual well on a well-by-well basis or, if there are multiple wells located on the same lease, does the test apply to all the wells as if they were one?



Generally, “the paying quantities test applies to all the lease wells as a whole and not separately to individual wells.”<sup>5</sup>

## **SHUT-IN WELLS IN OKLAHOMA**

Since Oklahoma does not require that actual production be in place at the end of the primary term in order for the lease to extend into the secondary term, the need for a shut-in payment is not as important in Oklahoma as it would be in the state of Texas. “If oil and gas is discovered by the end of the primary term, the lease is held by production if the lessee is making a diligent effort to sell the hydrocarbons. As such, the need for a shut-in clause in Oklahoma to prolong the lease is not nearly as important as in Texas. Failure to make shut-in gas royalty payments in the right amount or by the due date will not cause a lease to terminate.”<sup>6</sup>

## **HOW IS A GAS WELL SHUT-IN?**

To shut a well in is a simple matter. Large valves are installed at the top of the well in order to control the rate of the flow through the line. Wellsite personnel can open these valves or shut them off completely. Once these valves are closed the well stops producing and the well is shut-in.

## **FOOTNOTES:**

<sup>1</sup>South Texas College of Law, Student Bar Association, Oil and Gas Outline, Professor Strausser, 2004 [www.stcl.edu/students/sba/outlines](http://www.stcl.edu/students/sba/outlines).

<sup>2</sup>An Introduction to Kansas Oil & Gas Law, David E. Pierce, University School of Law, 1988, p. 53.

<sup>3</sup>The Arkansas Leasing Manual, Charles A. Morgan, 2005, [www.dnmlawfirm.com](http://www.dnmlawfirm.com).

<sup>4</sup>Termination of an Oil and Gas Lease, Real Estate Center, Technical Report 601, Judon Fambrough.

<sup>5</sup>Termination of an Oil and Gas Lease, Real Estate Center, Technical Report 601, Judon Fambrough.

<sup>6</sup>A Comparative Review of Oil and Gas Law in Texas, Oklahoma, Arkansas, New Mexico, Mississippi & Louisiana, Landman Oil & Gas law, Special Section, December 2002, George Snell, Timothy Dowd, Tom Daily, Gregory Nibert, John McDonald and Richard Revels, p. 93.