Shut-In and Cessation of Production: Current Considerations for Oil & Gas Producers

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With the recent significant decline in commodity prices, and physical transportation and storage curtailments, due in large part to reduced demand related to the COVID-19 pandemic, producers are evaluating many of their producing oil and gas wells to determine whether some level of reduced production is appropriate. In this alert, we attempt to highlight certain legal issues and considerations related to shutting-in or cycling wells, as well as potential risks associated with these actions. Finally, we identify and outline recent governmental and regulatory orders related to the current pricing crisis.

Please keep in mind that this alert provides only a general overview of significant issues (and may not address all issues relevant to a particular lease), and application of any of the items addressed will be highly dependent on the individual circumstances surrounding each lease and well, including the specific laws of the relevant legal jurisdiction and the agreements or documents governing a particular lease and well. Additionally, a single well may maintain multiple leases, and each affected lease may have differing provisions impacting the analysis. Further, many leases may have multiple wells, with each such well having its own economic characteristics, and therefore one well may hold a lease even though the same lease has multiple wells not then producing.

Producing in Paying Quantities to Hold Leases

The commonly understood rule in virtually all United States jurisdictions, including under federal leases, is that, unless a lease specifically provides otherwise, wells that are producing in paying quantities will be sufficient to maintain oil and gas leases beyond the primary term of the lease. Generally, to determine if a well is "producing in paying quantities" ("PPQ"), courts consider the following three factors: (1) whether the well has yielded a profit over operating costs over a reasonable period of time, (2) whether the well has a history of economic production (meaning operating revenues are greater than operating expenses, which may be exclusive of an operator's capital expenses, including acquisition, drilling and completion expenses), and (3) whether a reasonable and prudent operator would continue to operate the well. Notably, Texas courts have traditionally declined to draw a bright line on the period of time over which to evaluate these factors but have, instead, analyzed whether the period of time is "reasonable under the circumstances." *Clifton v. Koontz*, 325 S.W.2d 684 (Tex. 1959). Using this concept, Texas courts have held on multiple occasions that one year (and as much as two years) is probably too short of a time frame to analyze in determining PPQ. *See e.g.*, *BP America Prod. Co. v. Laddex, Ltd*., 458 S.W.3d 683, 686–87 (Tex. App.—Amarillo 2015), aff'd and remanded, 60 Tex. Sup. Ct. J. 542, 513 S.W.3d 476 (Tex. 2017); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 419 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.). Thus, there may be a wholistic analysis of activity and production under a lease (or leases), including a time-based component to the determination, with the implication that the determination will not necessarily be made over a relatively short period of time of limited or even no production.

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