NO. 15-0569

IN THE SUPREME COURT OF TEXAS

BP AMERICA PRODUCTION COMPANY,
Petitioner,

VS.

RED DEER RESOURCES, LLC
Respondent.

From the Seventh Court of Appeals, Amarillo
Court of Appeals No. 07-14-00032-CV
On Appeal from the 31st District Court, Lipscomb County, Texas
Trial Court No. 12-08-4372

AMICUS CURIAE BRIEF OF TEXAS LAND AND MINERAL OWNERS ASSOCIATION

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IDENTITY AND INTEREST OF AMICUS CURIAE
TEXAS LAND AND MINERAL OWNERS ASSOCIATION

Texas Land & Mineral Owners Association ("TLMA") submits this brief as Amicus Curiae. TLMA is a statewide advocacy association whose members are farmers, ranchers, and royalty owners. TLMA's interests are in a business and legal environment that is accommodating to the continued exploration for and production of oil and natural gas and that also protects the property rights of mineral owners. TLMA is paying the fees for preparation and submission of this brief.

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INTRODUCTION

TLMA submits this amicus brief in support of Red Deer Resources LLC's ("Red Deer") Motion for Rehearing. This case concerns a shut-in royalty clause that is found in many leases and the Court's rulings stand to impact lessors and lessees across Texas. The shut-in clause allows the lessee to shut-in a well on the lease that is "capable of producing" and pay a specified shut-in royalty for a 12-month period in lieu of actually producing and selling gas from the lease.

TLMA raises two points. First, the Court erred in choosing June 4 as the date for determining whether the well is capable of producing, because the well did actually produce on that date and, therefore, was "capable of producing" on that date. Under the terms of the shut-in royalty clause, the earliest date that could have been chosen was June 5, the day after the well had its last production.

Second, the Court erred in applying the doctrine of production in paying quantities to the shut-in royalty clause. To require the lessor to prove that a well is "incapable of production in paying quantities over a reasonable period of time as of" any particular date is inconsistent with the intent and purpose of the shut-in royalty clause. A shut-in royalty clause allows a lessee to shut-in a producing well when the lessee is unable to find a market to sell the gas or when the market is such that the lessee temporarily cannot profitably sell the gas. Requiring proof of paying quantities is inconsistent with that purpose. It also imposes an unreasonable, perhaps impossible, burden on the lessor. Ascertaining whether a well is producing in paying quantities is a retrospective examination of past production and past costs. Requiring proof that a well is incapable of producing in paying quantities going forward makes no sense.

ARGUMENT AND AUTHORITIES

I. Background of the Origin of Shut-In Royalty Clauses and the 60-Day Clause

Under most oil and gas leases, the lessee is allowed to retain the leasehold estate by drilling a producing well within the primary term. The habendum clause typically allows the lease (or a portion of it surrounding the well) to remain in effect as long as the well is producing.

Drafters of oil and gas leases early on considered the harshness of the habendum clause in terminating the leasehold estate because of temporary cessations of production, or where wells could not be produced because of lack of a gas market. To alleviate these issues and provide more certainty as to the duration of the secondary lease term, drafters crafted two provisions now found in all modern oil and gas leases: the 60-day clause (sometimes 90 days), and the shut-in royalty clause. The 60-day clause allows the secondary term to be extended when a well ceases production either for mechanical problems or because it has become depleted. The lessee may save the lease by commencing new operations to restore production within 60 days after cessation of production.

The shut-in clause is aimed at a different problem. If the well is a gas well, it may not be possible to produce the well immediately because of unavailability of a market or a pipeline connection; or the lessee may not want to produce the well because of lack of a satisfactory market for its gas. The shut-in clause allows the lessee to shut in such a well, pay a stated amount as "shut-in" royalty, and thereby continue the lease without actual production, usually for one-year intervals.

The lessee may take advantage of the shut-in clause only if the lessee's well is capable of producing at the time it is shut in. Otherwise, the purpose of the clause is not furthered by allowing extension of the secondary term by a monetary payment. If a well ceases production for mechanical problems or because it has depleted the reservoir, the lessee should be required to use the 60-day clause to extend the secondary term.

II. The Facts And Holding Here

The shut-in royalty clause in the Vera Murray oil and gas lease at issue here provides:

> Where gas from any well or wells capable of producing gas … is not sold or used during or after the primary term and this lease is not otherwise maintained in effect, lessee may pay or tender as shut-in royalty …, payable annually on or before the end of each twelve month period during which such gas is not sold or used and this lease is not otherwise maintained in force, and if such shut-in royalty is so paid or tendered and while lessee's right to pay or tender same is accruing, it shall be considered that gas is being produced in paying quantities, and this lease shall remain in force during each twelve-month period for which shut-in royalty is so paid or tendered.

Slip Op. at 11.

The facts show that the only well on the lease was a marginal gas well, averaging less than 10 mcf per day in 2009. By 2011, the well produced only sporadically, and it finally stopped producing in June 2012. Its last day of production was June 4, when it produced 10 mcf. On June 12, BP turned off the well valve and on June 13, BP tendered shut-in royalty under the lease's shut-in clause, quoted above. The jury found that the well was "incapable of producing in paying quantities when it was shut in on June 13."

This Court held:

> The shut-in clause in the Vera Murray lease unambiguously uses the date gas was last sold or used, not the date the shut-in royalty was paid or the date the valve was closed, as the operative date for determining a well's capability to produce gas in paying quantities *over a reasonable period of time*. Tender of the shut-in royalty at any time "before the end of the twelve-month period during which such gas is not sold or used" preserves the lease *from the last day on which gas was sold or used*, so long as the shut-in well *was capable of production in paying quantities on the day the last gas was sold or used*. Because the last gas was sold or used on June 4, Red Deer bore the burden of proving and obtaining a finding that the #11 well was incapable of production *in paying quantities over a reasonable period of time as of June 4, 2012*. Red Deer failed to do so. Accordingly, Red Deer failed to carry its burden to prove and obtain a finding that BP's exercise of its shut-in right was improper under the terms of the lease.

Slip Op. at 17-18 (emphasis added).

III. Point One: The "operative date" for determining whether the well was capable of producing must be at least the day *after* the well stops producing.

The Court's conclusion that the shut-in royalty clause makes the last day of production -- June 4 -- the "operative date for determining a well's capability to produce gas" is not correct. The well *was* capable of producing on that date: it produced 10 mcf of gas before it ceased production altogether. The "operative date" must be either June 5 or some date thereafter.

Under the shut-in clause, the shut-in royalty is payable any time "before the end of the twelve-month period during which such gas is *not* sold or used." That one-year period begins on June 5, the first day when gas was not sold or used. On June 5, and at all times thereafter, no gas was sold or used from the well.

To illustrate the error in the Court's reasoning, consider the following example:

> The only well on a lease ceases producing on June 4, 2012, because the casing has collapsed. Prior to June 4, the well was a good producer and was indisputably producing in paying quantities. After the last production on June 4, the well was not capable of producing at all without significant additional work on the well. The lease contains the same shut-in clause as the Vera Murray lease. Can the lessee preserve the lease by paying shut-in royalty?

Under the Court's holding, the answer would be yes. The Court has held that the "operative date for determining a well's capability to produce over a reasonable period of time" is the day the gas was last sold or used, June 4. According to the

Court, the lessee's payment of shut-in royalty will extend the lease "so long as the shut-in well was capable of production in paying quantities on the day the last gas was sold or used." Under our example, the well was certainly capable of producing "in paying quantities over a reasonable period of time" on June 4, the last day gas was sold or used -- before the casing collapsed on that day. So under the Court's holding, the lessee could extend the term of the lease for a year by paying shut-in royalty, even though, after the casing collapse, the well was not capable of producing any gas. The clause designed for these circumstances is the 60-day clause, which would require the lessee to promptly take steps to repair the well and make it operational again.

The use of June 13 in the charge to the jury was, at most, harmless error. BP turned off the well valve on June 12, thereby "shutting in" the well. The jury found that the well was not capable of producing in paying quantities on June 13, the day after the well was shut in. BP thought that the beginning of the shut-in period was June 13, because it designated that date as the beginning of the shut-in period. BP could have saved the lease by reworking the well and restoring production, as long as it commenced those operations within 60 days after the date of last production, under the lease's 60-day clause. Instead it tendered a shut-in payment, thereby asserting that it had the right to extend the lease for a year under the shut-in clause because, on the day it shut in the well, the well was "capable of producing gas."

TLMA supports Red Deer's assertion that, under applicable precedent, June 13 was a proper date to submit to the jury. By tendering shut-in royalty, BP took the position that the well was capable of producing on that date. That is the date the jury should consider. If the Court instead concludes that June 5 (not June 4) should have been the correct date for the Jury to consider, TLMA believes the jury charge using June 13 was harmless error. If the well was not capable of producing on June 13, there is no evidence that it would have been capable of producing on June 5.

IV. Point Two: The language in the shut-in royalty clause does not require production to be in paying quantities and its object and purpose are inconsistent with adding that requirement to the clause.

This Court created the concept of production in paying quantities in construing the habendum clause in an oil and gas lease. The requirement first appeared in *Garcia v. King*, 164 S.W.2d 509 (Tex. 1942). The Court there held that a lease providing it would remain in effect for 10 years "and as long thereafter as oil, gas, and other minerals is produced from said land" required that such production be "in paying quantities." 164 S.W.2d at 510, 511. The Court reasoned:

> In order to understand and properly interpret the language used by the parties we must consider the objects and purposes intended to be accomplished by them in entering into the contract. The object of the contract was to secure development of the property for the mutual benefit of the parties. It was contemplated that this would be done during the primary period of the contract. So far as the lessees were concerned, the object in providing for a continuation of the lease for an indefinite time after the expiration of the primary period was to

> allow the lessees to reap the full fruits of the investments made by them in developing the property. Obviously, if the lease could no longer be operated at a profit, there were no fruits for them to reap. The lessors should not be required to suffer a continuation of the lease after the expiration of the primary period merely for speculation purposes on the part of the lessees. Since the lease was no longer yielding a profit to the lessees at the termination of the primary period, the object sought to be accomplished by the continuation thereof had ceased, and the lease had terminated.

Id. at 512-13.

The same reasoning should be applied in construing the shut-in royalty clause in the Vera Murray lease.

In this case, the parties dispute whether BP's well was capable of producing at the time it was shut in so as to entitle BP to extend the secondary term by a full year by payment of shut-in royalty. The jury found that the well was not capable of producing when it was shut in, so the lease terminated.

The Court's opinion fails to construe the shut-in clause in light of the parties' purpose and intent: to allow the lessee to extend the secondary term if the well was capable of producing when it was shut in. Instead, the Court has required Red Deer to prove that the well was "incapable of production in paying quantities over a reasonable period of time as of June 4." Red Deer could not have met this test because (1) the well did in fact produce on June 4 and (2) there is no clear point at which a lease terminates because of a lack of production in paying quantities. The determination of "paying quantities" must be made in retrospect, looking at production and costs over a period of time. Once the well was shut in, this could not be done.

Whether a well is producing in paying quantities requires examination of the well's performance over a reasonable period of time. *Clifton v. Koontz*, 325 S.W.2d 684, 691 (Tex. 1959). In other words, under the Court's precedent, it is not possible to determine whether a well is producing in paying quantities on any particular day; instead, the well's performance must be measured over time, to see whether its revenues have exceeded its costs during that time.[1]

In this case, Red Deer contended that the lease had expired under the habendum clause because the well had failed to produce in paying quantities over a reasonable period of time -- *i.e.*, between April 27, 2009 and June 12, 2012. The first question to the jury addressed this contention, and the jury rejected it, finding that the well was producing in paying quantities over that time period.

But this finding did not end the matter, because Red Deer also contended the well was not capable of producing when it was shut in, so BP could not extend the lease by paying shut-in royalty. The shut-in royalty clause may be used to extend the lease term only if (1) there is no production from the lease ("gas is not [being] sold or used"), and (2) there is a well on the lease "capable of producing gas."

[1] "Because the operator is continuing to produce, although a minimal level, there is no clear point at which a lease terminates because of a lack of paying quantities." Ernest E. Smith and Jacqueline Lang Weaver, Texas Law of Oil and Gas, § 4.4[A][1], page 4-37 (2nd Ed.).

Whether a well is "capable of producing gas" on any particular day can be easily determined by opening the well to see if it flows. To apply the concept of production "in paying quantities" to the status of a well on June 4, or any other single day, is not a construction of the shut-in clause consistent with the purpose and intent of the clause.

Consider another example:

> A well produced revenue exceeding its costs during the period from April 27, 2009 to June 4, 2012, but the cost of operating the well from May 12, 2012 to June 12, 2012 exceeded revenues from production. Could the lessor terminate the lease because the well was not producing in paying quantities on June 4?

The answer must be no. A paying-quantities analysis requires examination of the well's performance over a reasonable period of time. But if the well was capable of producing on June 12 and was shut in on that day, the lessee could pay shut-in royalty and thereby extend the lease for a year, and "it shall be considered that gas is being produced in paying quantities" during such year. Conversely, if the well was not capable of producing gas on June 12, then tender of shut-in royalties could not extend the lease term because the well was not "capable of producing gas" on that date.

In several instances, the Court's opinion uses paying-quantity language to discuss the operation of the shut-in clause:

> In other words, tender of a shut-in royalty within twelve months of the last day gas is sold or used will sustain the lease through retroactive

> constructive production, so long as the well was capable of production *in paying quantities over a reasonably period of time on the date that gas was last sold or used.*
>
> Thus, to negate BP's invocation of its shut-in royalty rights, Red Deer bore the burden of proving that the #11 well was incapable of production *in paying quantities over a reasonable period of time as of June 4, 2012*.
>
> Because the last gas was sold or used on June 4, Red Deer bore the burden of proving and obtaining a finding that the #11 well was incapable of production *in paying quantities over a reasonable period of time as of June 4, 2012*.

Slip Op. at 12, 13-14, 18. If these statements form the precedent for future cases over shut-in payments, how can a lessor follow this precedent? Must the lessor prove that a well is incapable of production in paying quantities "over a reasonable period of time as of" the date the well ceased to produce? What does "as of" mean in this context? Does it mean that the lessor must prove that the lease terminated for failure to produce in paying quantities before the well stopped producing?

That, in fact, is BP's argument. It argues that, having failed to get a finding that the lease was not producing in paying quantities for the period leading up to June 4, the lessee cannot say that the well was incapable of production "in paying quantities" on June 4, or 5, or 12. Considering our first example, if a well is clearly producing in paying quantities on June 3 and the casing collapses on June 4, can the lessee extend the lease by paying shut-in royalty even though there is then no well "capable of producing gas"? Such a construction of the shut-in clause would allow a lessee to indefinitely extend a lease by paying shut-in royalty when there is no well on the lease capable of producing.

Shut-in clauses in leases are intended to address the situation when a well capable of producing has to be shut in because of lack of a market, a pipeline issue, or some cause other than mechanical failure or the well being depleted. If a well goes down because of mechanical problems or because it is depleted and can no longer produce, the lessee must rely on the 60-day clause in the lease to save the lease from termination. The shut-in clause was never intended to save a lease when no well capable of producing is on the lease.

V. The origin of the paying-quantities requirement shows that it should apply only to the lease's habendum clause.

The Court's conclusion that Red Deer had to show the well was "incapable of production *in paying quantities over a reasonable period of time as of* June 4, 2012" appears to be based on language to that effect in *Hydrocarbon Management, Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 433 (Tex. App.--Amarillo 1993, no writ) ("Reiterated, to permissibly shut-in a well, it must be capable of producing gas in paying quantities"). The court in *Tracker* cited *Kidd v. Hoggett*, 331 S.W.2d 515, 519 (Tex. Civ. App--San Antonio 1959, writ ref'd n.r.e.) for that proposition ("Shut-in royalty payments excuse production only if the well is actually capable of producing gas in paying quantities."). This Court cited *Tracker* with approval in *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 558 (Tex. 2002), concluding: "we hold that a well is capable of production if it is capable of producing in paying quantities without additional equipment or repairs." Red Deer followed this precedent in crafting its jury issues.

The courts' references to production "in paying quantities" in *Tracker, Hoggett* and *Thompson* appear to be the source of confusion about the role of "paying quantities" analysis in relation to shut-in royalties. TLMA believes that the use of "paying quantities" as a modifier to "capable of production" in these three cases was unnecessary to those decisions. In *Tracker* and *Hoggett*, the wells in question were not capable of producing at all, much less in paying quantities. There was no need to apply a paying-quantities analysis to the wells' production in order to decide those cases.

Likewise in *Thompson*, the issue was whether temporary cessations of production from a well caused a lease to expire where the habendum clause provided that the lease would remain in effect "as long thereafter as gas is *or can be* produced." The Court held that the temporary lapses in production did not terminate the lease because the well was still capable of producing. The Court quoted *Tracker* with approval for the proposition that a well is not capable of producing "if the well switch were turned 'on,' and the well did not flow, because of mechanical problems or because the well needs rods, tubing, or pumping equipment." 94 S.W.3d at 558. No argument was advanced as to whether the well--though capable of producing--was not capable of producing in paying quantities. The real holding in *Thompson* was that a well is "capable of production" only if it is capable of production without additional equipment or repairs. The Court's opinion on rehearing goes to great lengths to say that its opinion is not disturbing "our prior decisions regarding the proper interpretation of 'production in paying quantities.'" *Id.* at 559. This discussion would have been unnecessary if the Court had held that a well is capable of production if it is capable of producing without additional equipment or repairs and omitted any reference to paying quantities.

There is a long-accepted body of case law implying a paying-quantities analysis to the habendum clause of an oil and gas lease. As discussed above, this Court first imposed a paying-quantities requirement to a lease habendum clause in *Garcia v. King*, 164 S.W.2d at 513. In *Clifton v. Koontz,* the lessor contended its lease had terminated for lack of production in paying quantities. Citing *Garcia v. King*, the Court said: "While the lease does not expressly use the term 'paying quantities', it is well settled that the terms 'produced' and 'produced in paying quantities' mean substantially the same thing." *Clifton*, 325 S.W.2d at 690. But the opinion in *Clifton* also contained the following language, which indicates that a paying-quantities requirement should be read into a 60-day clause:

> It is only in the event of a finding of cessation of production in paying quantities that the trial court would be called upon to determine

> whether, if within 60 days from the date of such cessation, reworking operations were begun and resulted in profitable production thereafter.

Id. This unfortunate language was not necessary to the opinion, which upheld the trial court's conclusion that the lease had continually produced in paying quantities. Professors Ernest Smith and Jacqueline Weaver, in their treatise *Texas Law of Oil and Gas*, comment as follows:

> More questionable is the language in several cases [citing *Clifton v. Koontz* as an example] suggesting that this type of lease clause [a 60-day rework clause] is relevant where production continues but is not in paying quantities. If this construction is applied, the lessee under such a clause will presumably have sixty days in which to rework any well which either ceases production entirely or ceases production in paying quantities. It seems highly doubtful that the parties intended such a construction. The language of the clause is clearly directed at the situation where production ceases altogether, not where it merely becomes marginal. Adding sixty more days to an "event" as ambiguous as cessation of paying quantities is not likely to add materially to the certainty of the parties' rights.

Smith & Weaver, § 4.4[B][2], page 4-46.

Just as it is not logical to imply "paying quantities" in a 60-day clause, it is also not logical to imply "paying quantities" in a shut-in royalty clause. As this Court said in *Garcia v. King*, to properly interpret the "the language used by the parties we must consider the objects and purposes intended to be accomplished by them in entering into the contract." 165 S.W.2d at 512. Applying a paying-quantities analysis to a shut-in royalty clause does not further the intended purpose of the clause.

Red Deer crafted its jury charge based on the "paying quantities" requirement expressed in *Hydrocarbon Management v. Tracker* and *Anadarko v. Thompson*. The result is a confusing question, created by confusing precedent. Red Deer should not be punished for such confusion. The jury concluded that the well had depleted and was not capable of producing when it was shut in. Any error in the jury question should be considered harmless.

CONCLUSION

The amicus briefs submitted after the Court's opinion show the importance of this case to landowners, operators and the oil and gas bar. This brief is TLMA's effort to shed some light and clarity on a confusing area of the law that this Court should address. TLMA respectfully requests that the Court grant Red Deer's motion for rehearing, reconsider the issues in light of this confusion, and issue a new opinion addressing the problems created by courts' precedent.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Tex. R. App. P.9.4(i)(2)(B) because it contains 4,376 words, excluding the parts of the brief exempted by Tex. R. App. P. 9.4(i)(l). The undersigned relied on the word count of MS Word, the computer program used to prepare the brief.

/s/ Mary A. Keeney
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CERTIFICATE OF SERVICE

By my signature below, I hereby certify that a true and correct copy of the above and foregoing document has been sent e-file to all parties of record on this the 8th day of August, 2017.

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