

Preparing for a Shut-In: Key Lease-Preservation Factors to Consider When Shutting-In a Well

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As the energy industry continues to suffer from historically low prices caused by both an oversupply of oil and an unprecedented shock to demand, for the first time in many years, producers have begun shutting-in wells on a large scale due to market conditions. Different states' regulatory authorities are even in the process of reviewing requests to shut-in certain wells, or are issuing orders to limit the potential consequences of shutting-in wells in light of the current economic environment.

Subject to any such regulatory developments relevant to the well in question, when parties are looking to shut-in a well, there are a number of key items that should be reviewed in the respective agreements associated with the well to confirm the availability of an applicable shut-in royalty clause, determine the responsibility for making any required payment, and assess any risks associated with shutting-in without such payment(s).

I. Preface

Oil and gas leases typically include a habendum clause (or term clause) that states that the lease will remain in effect for a defined "primary term" and as long thereafter as oil and gas is produced in paying quantities. If for any reason the lessee is unable to produce the well in paying quantities at any time after the end of the primary term, the lessee should consider whether there is an alternative basis to preserve the lease, such as a shut-in royalty clause.

Shut-in royalty clauses permit the lessee to make a payment (a shut-in royalty), under certain circumstances, to maintain the lease as if production in paying quantities continued during the period in question. While shut-in clauses are common today, it is important to note that not all oil and gas leases include a shut-in royalty clause. Additionally, even if included, a shut-in clause may not necessarily require payment for all completed wells that are shut-in on a leased premises.

But, generally, a shut-in royalty payment is only able to maintain a lease if certain conditions set forth in the lease are met. This article identifies the specific provisions to keep an eye out for when reviewing documents if the applicable lease includes a shut-in royalty clause allowing for the lease to be maintained through payment of a shut-in royalty to the lessor.

Separately, it is important to note that, if a lease does not include a shut-in royalty clause, there are other lease provisions, including cessation of production and force majeure clauses, that may provide other bases by which the lease can be preserved.

II. Agreements to Review

The relevant oil and gas leases are, of course, the most important agreements to review. As noted above, while leases today often include shut-in royalty clauses, the shut-in provision will

only allow a lease to be maintained if it is applicable to the situation at hand and shut-in royalties are paid when due.

In addition to leases, other related upstream documents such as operating agreements, joint development agreements, etc. should be reviewed as they often include provisions concerning the responsibility for making shut-in well payments. Furthermore, because a lease's shut-in royalty clause may also cover wells completed on lands pooled with lands covered by such lease, all leases within a collective unit or pooling group should be reviewed, and other relevant matters including, but not limited to, reservoir and well engineering considerations, regulatory requirements, requirements under credit agreements, etc. should be identified and reviewed when contemplating shutting-in a well.

III. Shut-In Royalty Clause

It is critical to remember that not all shut-in royalty clauses are the same. Often, a shut-in royalty clause may be the result of various degrees of negotiation between the parties.

When reviewing a shut-in royalty clause, the first point to confirm is the type(s) of wells the shut-in royalty clause applies to, as a particular clause may only apply to gas wells, gas and oil wells, or any producing well within the leased premises. Though shut-in royalty clauses were traditionally drafted with respect to gas wells, due to the inability to store the natural gas produced therefrom, most industry form leases used today do not expressly limit the application of their respective shut-in royalty clauses to gas wells only. Regardless, due to the variation among leases still in effect today, this is the important, first factor to investigate.

Second, it is important to confirm that any conditions set forth in the shut-in royalty clause have been satisfied. Shut-in royalty clauses may include language such as "while there are one or more [gas] wells completed hereunder as capable of producing in paying quantities, but because of governmental regulations or lack of a market or marketing facilities there is no current production" Based on the language of this clause, this shut-in royalty provision would only apply if, in fact, the ability to produce or market production is prevented by regulation, lack of a market, or lack of marketing facilities (a pipeline). Absent those circumstances, the lessee would need to look for other bases to preserve the lease if it plans to shut-in the well(s).

If a shut-in royalty clause applies to the well(s) sought to be shut-in, the next information to look for is *when* shut-in royalties must be paid to maintain a lease when a well capable of production is shut-in. The shut-in royalty clause will provide how soon after production ceases that shut-in royalty payment(s) must be made in order to maintain the lease, as well as how often such payments must be made, and any maximum period such payments can maintain the lease without production. The duration for which the payment of shut-in royalties can maintain a lease varies among leases. Some allow the lease to be maintained indefinitely through the continuous, timely payment of shut-in royalties, while others only permit the lease to be maintained by the payment of a shut-in royalty for a limited time, after which the lease will terminate.

IV. Responsible Party to Pay Lessor

Once the terms and conditions of a lease's shut-in royalty clause are understood, any applicable operating agreement and/or other upstream development, operation or sharing agreements that cover the well(s) to be shut-in should be reviewed to determine who is responsible for communicating with, and making any relevant shut-in royalty payment(s) to the lessor(s).

Like the variety in shut-in royalty clauses, the identity of the parties responsible for making shut-in royalty payments also varies from agreement to agreement. Thus, it is critical to review all relevant, upstream documents. For example, under Article VII.E. (*Rentals, Shut-In Well Payments and Minimum Royalties*) of the AAPL 610 Model Form Operating Agreement ("AAPL JOA"), any shut-in well payments required under the terms of a lease shall be paid by the party or parties that contributed the lease subjected to such AAPL JOA. However, this provision is often revised to make the operator (not the lessee) responsible for making such payments.

Notably, under the model language of another AAPL JOA provision, Article VI.B.2. (*Loss by Non-Payment or Erroneous Payment of Amount Due*), there is no monetary liability against the responsible party who fails to make a shut-in well payment required to maintain a lease. But if the AAPL JOA Article VII.E. language (referenced above) is revised to make the operator or another party responsible for making shut-in well payments, the Article VI.B.2. provisions governing liability for failure to make the shut-in well payments are also typically revised.

Alternatively, if AAPL JOA Article VII.E. is not revised, and the non-operator party that contributes a lease remains responsible for making required shut-in well payments, the second paragraph of Article VII.E. in the AAPL JOA states that the operator shall notify the responsible non-operator party of an anticipated well shut-in or return to production. If the operator fails to provide such notice to the responsible non-operator and the lease terminates due to the failure to make a timely shut-in payment, pursuant to AAPL JOA Article IV.B.3, such loss will be borne *jointly* by all of the parties to that AAPL JOA, in proportion to their interests therein.

In light of the scope of the potential loss, when a shut-in royalty clause will be relied upon to preserve a lease, identification of the party responsible for making required shut-in royalty payment(s) for any well to be shut-in, as well as how liability resulting from non-payment of an applicable required shut-in royalty will be allocated, are all important factors to investigate and understand before shutting-in wells, today or at any time in the future.