RETHINKING THE OIL AND GAS LEASE: THREE STEPS TOWARD CREATING A MARKET-RESPONSIVE OIL & GAS LEASE

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THREE STEPS TOWARD CREATING A MARKET-RESPONSIVE OIL & GAS LEASE

I. The Lease "Relationship"

One of the most interesting aspects of oil and gas law is the prevalent use of relational contract concepts to define each party's rights and obligations in a transaction. Perhaps there is no better example of the relational contract than the oil and gas lease. See generally Pierce, Rethinking the Oil and Gas Lease, 22 Tulsa L. J. 445 (1987). A "relational" contract is one in which the underlying relationship of the parties, created by the terms of the contract, tends to define, and redefine, their respective obligations to one another. Evaluating and characterizing the relationship becomes an important component of the contract interpretive process. Once a court's general view of the relationship is known, its interpretation of the express contract terms can be more accurately predicted.

When dealing with an oil and gas lease, courts may weigh factors concerning the contract-formation process which directly impact its ultimate interpretation of the lease terms. For example, the court may examine the relative bargaining positions of the parties and conclude the landowner (lessor) needs protection. "Freedom of contract" principles

cause the courts to refrain from voiding what they may perceive to be a "bad deal" for the landowner. Courts have generally been reluctant to police the bargain-formation process absent a clear showing of fraud. See Silk v. Phillips Petroleum Co., 59 Okla. B. J. 1688 (June 21, 1988) (in the process of executing an oil and gas lease, the landowner inadvertently signed an option to renew the lease for an additional 5 years; the landman never mentioned the option but merely presented the documents for the landowner's signature a few days after they had negotiated the terms of the lease - Held - since the landman made no statements regarding the documents he had no duty to disclose the existence of the option). Compare Zimpel v. Trawick, 679 F.Supp. 1502 (W.D. Ark. 1988) (landman purchased mineral rights after discussing the general depressed nature of the oil and gas business; the landman knew a good well had been completed near the property - Held - although he had no duty to disclose, once he mentioned the depressed nature of the industry he assumed a duty to make an accurate disclosure of the situation).

Although courts have been reluctant to police the bargain-formation process, they have come to the aid of the "disadvantaged" party through benevolent interpretation of the resulting agreement. Often this "interpretation" is grounded not on the specific terms of the agreement, but rather on the

"relationship" the contract is deemed to create. For example, would it be "fair", considering the relationship created by the contract, to permit the lessee to hold the lease through mere "production?" The contract, in the habendum clause, provides the lease will remain in effect "so long as oil or gas is produced from the leased land." The plain meaning of the contract seems to contemplate that any amount of production will keep it in effect. However, the courts have looked to the relationship and found that it would be unfair to permit the lessee to retain the lease when only nominal amounts of production are being obtained - i.e. not enough to cover current operating expenses. Therefore, the parties must have intended "production" to mean "production in paying quantities."

Note how this process has generally tended to return to the landowner something the developer obtained through, what court's often perceive to be, a one-sided bargain. Also, the effect of such interpretations has been generic - applied to all oil and gas lease relationships. This has given rise to the maxim, which operates in most states (Oklahoma is the major exception), that when in doubt, the lessee always loses. Therefore, it in incumbent upon the lessee to mold the relationship through careful drafting to try and eliminate doubt whenever possible. This is particularly important when

the lease provisions relate to the continued life of the relationship - such as the production requirement or the operations, cessation, and shut-in royalty clauses.

II. Market-Related Problems and Solutions

The current form of oil and gas lease is extremely market-sensitive; market conditions determine its continuing validity. Anyone experiencing industry developments during the last decade will attest that the oil and gas market is volatile. Yet the oil and gas lease, the life of which is indexed to the price of oil and gas, gives the lessee little flexibility to react to the changing economic and regulatory climate. The habendum clause, and other clauses designed to perpetuate the lease beyond the primary term, are woefully inadequate for allowing the lessee to "prudently" respond to adverse economic and regulatory events.

The sections that follow focus upon three areas where the lease relationship needs to be redefined to account for the volatile oil and gas market in which it must operate. Although many of the proposed provisions will enhance the position of the lessee, lessors will be benefited by defining, in the lease, exactly what will continue it in effect.

Disputes over the contours of the existing "standard" lease relationship are legion. Our goal should be to draft a lease which minimizes problems and clearly declares the "winner" or "loser" at the negotiation stage of the transaction instead of the post-contract litigation stage. Of course, saying there is meaningful "negotiation" of lease terms is often a misnomer. Therefore, the potential for judicial intervention to protect the landowner will always be present. To combat judicial attempts to protect the landowner after the bargain is made, attorneys representing developers must be careful not to "overdraft" or "underdraft."

"Overdrafting" would include, for example, an attempt to exempt the lessee from any obligation to obtain production. Such an agreement, if it survives the initial test of unconscionability, will certainly meet with harsh judicial interpretation. It is likely the "relationship" will prevail over the terms of the "contract." Although on paper you appear to have obtained more for your client, you have failed. "Underdrafting" can also be a problem. There has been a historical tendency to try and express obligations in the oil and gas lease through various short-hand expressions, such as "market value." Lessees generally lose when such terms are the focus of a dispute.

An example of "underdrafting" (which also has an "overdrafting" impact) is the habendum clause which provides the lease will remain in effect "so long as oil or gas is produced or producible from the land." The lessee would argue that so long as the well is capable of producing in paying quantities, the lease, by the express terms of the habendum clause, continues in effect. In Greer v. Salmon, 82 N.M. 245, 479 P.2d 294 (1970), the lessee, under a similarly worded lease, argued that so long as gas was "producible" from the land the lease could not be terminated for a failure to timely pay shut-in royalties. The court observed: "Numerous cases have stated that the primary purpose of an oil and gas lease is to obtain production from which the lessor will be paid a royalty." Noting that lessee's interpretation would thwart this "primary purpose", the court held the shut-in royalty clause controlled and failure to timely make the required payment caused the lease to terminate - even though at all times there was a well that was "producible" on the leased land.

The remedy for underdrafting is not to "say it twice." Instead, you focus on the particular problem you need to overcome and address the problem with language all parties can understand. The cryptic code of the oil and gas lease is largely a product of trying to cram the agreement into a

single page. Presumably this is so the landowner will not be inclined to take the document too seriously but instead will enter into it in the same manner they enter into other "standard form" contracts - "Where do I sign?" Lessee's are starting to find that contract rights that have been "taken" from the landowner are more difficult to administer than rights that have been "given" by the landowner after meaningful negotiation.

We next examine some of the problems which the lessee has created under the typical form of oil and gas lease which is still routinely used. The most striking aspect of these problems is that they are generally self-inflicted.

A. Production in "Paying Quantities"

1. Traditional Approach

The typical form of habendum clause extends the lease grant "for so long as oil or gas is produced from the leased land." Early problems concerning the need for actual production from the land at the end of the primary term have been alleviated by the addition of completion, dry hole, cessation, shut-in royalty, force majeure, and pooling clauses. However, nothing as been done to mitigate the

requirement of production in "paying quantities." It is the "paying quantities" aspect of the lease over which the lessee has little or no control. Lessees are at the mercy of the price of oil. A commodity that is now priced by international entities and events beyond the control of the lessee, or the United States.

All major producing states addressing the issue have placed a "paying quantities" requirement on the type of production needed to perpetuate the lease beyond its primary term. The relational contract aspects of the requirement were noted in Garcia v. King, 139 Tex. 578, 164 S.W.2d 509 (1942), where the Court observed:

> 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 the 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 investements 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.

The paying quantities requirement is met when the value of production exceeds operating costs. In Walden v. Potts, 194 Okla. 453, 152 P.2d 923 (1944), the court held "paying quantities" means: "if oil is actually produced in such quantities as will pay a profit to the lessee over operating expenses it is produced in paying quantities, though it may never repay the cost of drilling and equipping the well or wells." Walden, 194 Okla. at 455, 152 P.2d at 924. However, resolving the issue requires more than merely identifying gross income and then deducting allowable expenses. The time period over which the comparison is made must first be established. Although a well may not show a profit during a particular month or quarter, it may show a profit over a longer period of time. Selecting the appropriate accounting period is primarily guided by what the court believes is sufficient to provide the "prudent operator" with information to decide whether to maintain the lease.

As the Texas Supreme Court observed in Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959):

> In the case of a marginal well, . . . the standard by which paying quantities is determined is whether or not under all the relevant circumstances a

> reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, would continue to operate a well in the manner in which the well in question was operated. . . . Whether there is a reasonable basis for the expectation of profitable returns from the well is the test.

In _Texaco, Inc._ _v._ _Fox_, 228 Kan. 589, 618 P.2d 844 (1980), the Kansas Supreme Court offers the following guidance concerning the selection of the proper accounting period:

> [I]t is generally accepted that profitability on an oil and gas lease should be determined over a relatively long period of time in order to expose the operation to the leveling influences of time. The arbitrary use of a short period of time while a well is down for a workover is obviously untenable. On the other hand, the use of an unreasonably long period would entail using past glories during flush production to determine a lease's present condition, which would give a distorted result not reflective of the current status of the lease. The better rule precludes the use of a rigid fixed term for determination of profitabilty and uses a reasonable time depending upon the circumstances of each case, taking into consideration sufficient time to reflect the current production status of the lease and thus to provide the information which a prudent operator would take into account in whether to continue or to abandon the operation.

Texaco, 228 Kan. at 591, 618 P.2d at 847.

Often, selecting the applicable accounting period will determine whether the lease is producing in paying quantities or is no longer in effect. Once the accounting period is selected, the focus will shift to the production proceeds that will be credited to the lessee as gross income and the expenses that will be subtracted from gross income to arrive

at net income, or loss. Each element of the equation: accounting period, items of income, and items of expense, have been, and continue to be, the subject of litigation.

However, the major weakness of the traditional approach is the market-sensitive nature of the mechanism: if the price of oil drops, a lease which would otherwise remain in effect may terminate. In November 1985 a barrel of West Texas Intermediate crude sold for $30.70; 120 days later, in March 1986, it sold for $11.50 a barrel - a $19.20/barrel drop in four months. The only flexibility built into the system is the "prudent operator" standard for evaluating lessee's intent in continuing to operate the lease. I don't find this very reassuring.

2. A Suggested Approach

The approach I offer in this section assumes the landowner will read the lease and will be disinclined to give their lessee a "blank check" regarding the duration of the lease. Therefore, I will not discuss attempts to require merely "production" as opposed to "production in paying quantities." Although I believe the public would be better served by a rule which merely requires "production" in any quantity sufficient to market. See Pierce, Rethinking the Oil and Gas Lease, 22

Tulsa L. J. 455, 467-69 (1987). My suggested approach uses a habendum clause tied to production in paying quantities - as defined by the lease. The key matters that must be addressed include:

(1) How do the parties want to determine paying production?

(2) What income will be allocated to the lessee?

(3) What expenses will be deducted from income?

(4) What period of time will be used to compare income and expenses?

Consider the following clause:

SECTION 4. PRODUCTION

The duration of this Lease will extend beyond the Termination Date for so long as there is Production of one or more of the Leased Substances, in Commercial Quantities, from the Leased Land.

A. "Production" means:

The actual extraction of one or more of the Leased Substances from the Leased Land.

B. "Commercial Quantities" means:

The Value of Leased Substances extracted from the Leased Land exceeds Current Operating Costs during an appropriate Accounting Period.

C. "Value" is determined by multiplying the Production attributed to LESSEE times the Price of such Production.

D. Production attributed to LESSEE.

LESSEE will be deemed to receive 7/8ths of all Production, regardless of what LESSEE's actual share of Production may be

after deducting royalty, nonoperating interests, and any other interests payable out of the leasehold interest.

E. Price of Production.

Production sold during the Accounting Period will be deemed to have been sold for an amount calculated by taking the average price paid for extracted Leased Substances during the Accounting Period, adding to such average price the highest price ever paid for extracted Leased Substances during the existence of the Lease, and then dividing the total by two.

F. "Current Operating Costs" include only amounts actually paid by LESSEE which relate directly to the operation of a well or wells on the Leased Land. The following costs are representative of items which will be included as Current Operating Costs:

1. Energy purchased to operate equipment used to produce Leased Substances.

2. Taxes relating to Lessee's actual share of production from the Leased Land.

3. Material and labor necessary for the routine maintenance of wells.

4. Material and labor necessary for the routine maintenance of roads and other structures on the Leased Land used to support production.

[5. Transportion of production.]

The following costs are representative of items which will <u>not</u> be included as Current Operating Costs:

1. Drilling, completing, and equipping wells.

2. Replacing major items associated with the continued operation of the Lease. This includes such things as replacing pumping units, tubing, casing, wellhead apparatus, separators, heater-treaters, injection wells, and storage tanks.

3. Stimulating wells, to include fracturing, acidizing, and similar techniques.

4. Reworking operations designed to regain or improve production from a well.

5. Planning for Enhanced Recovery operations and the cost of any pilot project to determine whether Enhanced Recovery techniques are feasible.

6. Overhead, depreciation, and income taxes.

7. Plugging wells and reclaiming affected surface areas.

8. Pipelines necessary to deliver Production to a purchaser.

G. "Accounting Period" means:

A period of time which adequately reflects the productive potential of the Leased Land. The Accounting Period should be long enough to provide LESSEE with sufficient information to determine whether to continue operating the Leased Land. If LESSEE is conducting Enhanced Recovery operations on the Leased Land, the Accounting Period should be long enough to evaluate the success of such operations. [In any event, the Accounting Period will not be less than <u>24</u> consecutive months.]

A problem closely related to the paying quantities requirement is the cessation of production. If the cessation is permanent, the lease will terminate - absent a special lease provision addressing such an event. If the cessation is temporary, the lessee will have a reasonable amount of time to regain production. The traditional response by lessees has been to use a "cessation" clause similar to the following:

> "If, after the expiration of the primary term of this Lease, production on the leased premises shall cease from any cause, this Lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues."

Such a clause eliminates the flexibility provided under the common law temporary cessation doctrine. It can also prove disasterous when cessation is defined as a lease which ceases to produce in paying quantities as opposed to a total stoppage of production. See Hoyt v. Continental Oil Co., 606 P.2d 560 (Okla. 1980) (cessation clause requires lessee to commence drilling or reworking operations within 60 days from date well ceased to produce in paying quantities).

The following cessation clause retains the flexibility of the temporary cessation doctrine while addressing the permanent cessation:

SECTION 6. CESSATION OF PRODUCTION

A. TEMPORARY CESSATION.

LESSOR and LESSEE recognize that Production will be interrupted periodically for well maintenance, reworking, and other activities. Such temporary cessations of Production will not terminate the Lease so long as LESSEE takes action within a reasonable time to restore Production.

B. PERMANENT CESSATION.

If Production ceases, due to an exhaustion of recoverable Leased Substances from exisiting wells, LESSEE has ninety (90) days following the date of such cessation to begin Operations in an effort to regain Production in Commercial Quantities from the Leased Land.

Sample Problem Demonstrating "Paying Quantities" Calculation

Big Oil Company leases the Northwest Quarter of Section 30 from Fred Farmer in 1979. Since the price of oil is at about $34/barrel, Big Oil drills a well on Section 30. From 1979 through 1982 the well produces, on average, 35 barrels of oil each day. Production gradually declines; the well is currently producing 2 barrels each day. If the issue is litigated in 1986, the price of oil may be as low as $9/barrel.

Under the traditional form of habendum clause, courts generally look at the current value of oil to determine whether the lease is producing in paying quantities. This is multiplied by the quantity of production to arrive at the base revenue figure.

If the issue arose while oil was selling for $9/barrel, and production was 2 barrels each day, and assuming a 1/8th royalty under the lease, the daily income credited to the lessee will be $15.75 ([2 x $9] x 7/8).

Applying the formula in my alternative drafting response, SECTION 4. E., assume the accounting period is set at the most recent 24 month period. During that time oil sold for $25,

20, 15, 11, and 9/barrel. The average price for oil sold during the accounting period would be $16/barrel ([25 + 20 + 15 + 11 + 9] divided by 5).

Add to the $16 price the highest price ever paid for oil during the existence of the lease; in this case $34/barrel. This gives us $50 which is then divided by 2 to arrive at the "Price of Production" for calculating paying quantities under the habendum clause - $25/barrel.

Therefore, daily lease income attributed to the lessee would be $43.75 ([2 x $25] x 7/8) instead of $15.75.

B. Inability to Market Production

1. Traditional Approach

Another market-related problem is selling production. Most shut-in royalty clauses contemplate a total inability to market and are limited to gas marketing problems. They also use language which indicates proper payment of the shut-in royalty is a condition to the continued existence of the lease. A traditional form of shut-in royalty clause provides:

> [I]f there is a gas well . . . on the . . . land . . . and such well or wells are shut in before or after

production therefrom, lessee . . . may pay . . . at the end of each yearly period during which such gas well or gas wells are shut in, as substitute gas royalty, a sum equal to the amount of delay rentals . . . and if such payments or tenders are made it shall be considred under all provisions of this lease that gas is being produced . . . ."

One of the major problems created by the traditional form of shut-in royalty clause is the use of special limitation language to describe the payment option. This seems odd since a lessee will seldom want to surrender a well, or wells, capable of producing in paying quantities. See, e.g., Amber Oil & Gas Co. v. Bratton, 711 S.W.2d 741 (Tex. Ct. App. 1986) (lessee accidentally paid shut-in royalty to wrong party - lease terminated). But see Gard v. Kaiser, 582 P.2d 1311 (Okla. 1978) (failure to comply strictly with shut-in clause will not result in automatic termination of the lease). This problem can be readily solved.

A more difficult problem is determining when the lessee can declare a well shut in. Most shut-in clauses are silent regarding the type of events that will justify placing the well in shut-in status. It is likely courts, absent specific authorization, will limit the clause to situations where the lessee is diligently searching for a market -- for a well capable of producing in paying quantities. Such an interpretation is further supported by the lease limiting the right to declare shut-in status to gas wells.

2. A Suggested Approach

The clause that follows is designed to avoid the use of special limitation language. It expands considerably the types of events that will justify shut-in status. Each of the events will provide the lessee with the flexibility needed to avoid "fire-sale" product prices and unreasonable marketing charges. I have also elected to structure the shut-in payment as an advance royalty. This permits the lessee to pay a larger sum to placate the royalty owner while the well is shut in.

Consider the following clause:

SECTION 7. UNABLE TO MARKET PRODUCTION

If the Leased Land is capable of Production in Commercial Quantities, but LESSEE is unable to market Production because of the Inability to Access a Market, Unacceptable Terms, or Market Conditions, and this Lease is not being maintained by the terms of another Lease clause, this Lease will be deemed to be Shut-in.

The duration of this Lease will extend beyond the Termination Date for so long as a Shut-in well exists on the Leased Land.

If LESSEE is relying upon this Section to extend the Lease beyond the Termination Date, and Production is Shut-in for ninety (90) consecutive days, LESSEE will pay to LESSOR $500.00 as an Advance Royalty. If Production remains Shut-in, LESSEE will pay LESSOR $500.00 for each period of 365 consecutive days following the initial ninety (90) day period. LESSEE will pay any Advance Royalty due under this Section within a reasonable time following the close of the Shut-in period entitling LESSOR to Advance Royalty. LESSEE's failure to properly pay the Advance Royalty will make the LESSEE liable for the amount due but will not operate to terminate this Lease.

a. "Inability to Access a Market" means:

The unavailability of an acceptable mode of transportation to deliver Leased Substances to a buyer.

b. "Unacceptable Terms" means:

Offered contract terms which are not reasonable when compared with terms of existing contracts with other producers similarly situated to LESSEE. If comparison is not possible, then any term which a reasonable person in LESSEE's position would find unconscionable. The terms may relate to an offer to buy, gather, transport, treat, process, or market Leased Substances.

c. "Market Conditions" means:

The market price being paid for a Leased Substance is such that a reasonable person in LESSEE's position, having the power to do so, would refrain from marketing the Leased Substance.

d. "Shut-in" means:

A well capable of Production which is not being produced.

e. "Advance Royalty" means:

A payment made under this Section which LESSEE can recoup, dollar-for-dollar, from future royalty payable to LESSOR. LESSEE can recoup Advance Royalty only to the extent there is future royalty payable to LESSOR.

C. The Royalty Obligation

In this section I will focus only on the portions of the royalty clause which impact the lessee's calculation of net proceeds from lease operations. The major impact may be on the lessee's lease-related legal expenses required to litigate the numerous opportunities for dispute under the traditional form of royalty clause.

1. Traditional Approach

The typical form of lease provides for the payment of royalty based upon the "gross proceeds" derived from a sale of production or the "market value" of production sold or used off the leased premises. Generally, the value or proceeds will be calculated "at the well." Major unresolved problems

caused by the traditional approach include:

(1) What costs can be deducted in calculating the lessor's royalty?

(2) To what extent can the lessor assert a right to a share of products processed from production?

(3) What are proceeds? Do they include other rights under the gas purchase contract?

Courts will soon be called upon to address many of these issues in new contexts. For example, is the gas marketer's fee a "transportation" expense?

2. A Suggested Approach

The clause that follows is drafted to try and maximize the position of the lessor.

SECTION 10. ROYALTY

LESSEE will pay to LESSOR a Royalty as follows:

A. LESSOR'S SHARE OF PRODUCTION.

1. LEASED SUBSTANCES.

There is excepted from this Lease and retained by LESSOR, out of Production from or attributable to the Leased Land, 12.5% of all Leased Substances Produced And Saved.

2. PRODUCTS FROM LEASED SUBSTANCES.

If LESSEE, or any affiliate of LESSEE, Processes a Leased Substance, LESSOR is entitled to 12.5% of the Leased Substance after Processing. LESSOR has the continuing option to either receive a Royalty on a Leased Substance before or after Processing. LESSOR elects, at this time, to receive Royalty on Leased Substances after Processing.

B. COSTS.

1. DEVELOPMENT, PRODUCTION, PROCESSING, AND MARKETING COSTS.

LESSOR's Royalty is not burdened by any expenses or charges relating to developing, producing, treating, gathering, transporting, processing, manufacturing, or marketing Leased Substances or Processed Leased Substances. Such expenses, whether characterized as a production or post-production expense, are payable solely from LESSEE's share of Production.

2. TAXES.

Properly assessed taxes, levied against LESSOR's Royalty, can be deducted from LESSOR's Royalty to reimburse LESSEE or any third party properly paying such taxes.

C. OPTION TO TAKE IN KIND.

LESSOR has the continuing option to take all or any part of Royalty in kind by giving LESSEE notice at least 30 days prior to the effective date of LESSOR's election. LESSOR will give LESSEE similar notice in advance of ceasing to take in

kind. In the event LESSOR elects to take in kind, LESSOR can require LESSEE to deliver Royalty, without cost to LESSOR, to the pipelines, tanks, separators, or manufacturing plant tailgates which wells on the Leased Land may be connected.

D. VALUE OF PRODUCTION NOT TAKEN IN KIND.

To the extent LESSOR has not elected to take Royalty in kind, LESSEE will pay LESSOR an amount equal to the greater of:

1. GROSS PROCEEDS.

The gross proceeds from the sale of Leased Substances; or

2. MARKET VALUE.

The market value of Leased Substances. It is presumed that a current sale of Leased Substances, to a third party in an arms-length transaction, represents market value.

3. SALES CONTRACTS.

If LESSEE plans to commit its share of Production from the Leased Land to a sales contract, LESSEE will provide LESSOR

with a copy of the proposed sales contract. LESSOR has the option, within 30 days following receipt of the sales contract, to elect to have Royalty calculated according the the terms of the sales contract. If LESSOR elects, in writing, to commit to the sales contract, LESSEE will calculate LESSOR's Royalty based upon the proceeds paid to LESSEE under the approved contract.

However, LESSOR's Royalty will be calculated as though any automatic price escalation clause, or other provisions having the potential to increase proceeds payable on production, (such as take-or-pay rights and severance tax reimbursements), became effective on the earliest date permitted under the contract. Royalty will be paid as though such amounts were paid to LESSEE, even though LESSEE fails to initiate the process to become entitled to the increased proceeds or fails to actually collect such increased proceeds.

E. PAYMENT.

LESSEE will pay LESSOR's Royalty no later than 90 days after Production is obtained from the Leased Land. After the first Royalty payment, subsequent payments will be made no later than 15 days following the month in which the Leased Substances were produced. Any amount not paid when due under

this Subsection will bear interest at an annual percentage rate of 18%.

[Payment documentation - monthly accounting information.]

F. DIVISION ORDER

LESSOR agrees to sign division orders certifying LESSOR's ownership interest in Leased Substances and the Leased Land to prevent LESSOR, while the division order remains unrevoked, from claiming any greater ownership interest for purposes of the payment of Royalty. Any division order signed by LESSOR must be revokable at LESSOR's election.

[Better approach - attach form of division order you are willing to sign (or accept)].

G. DEFINITIONS.

1. "Royalty" means:

LESSOR's share of Production provided for by this SECTION.

2. "Produced And Saved" means:

The Leased Substance has been extracted from the Leased Land and is available for sale or use. Any intentionally flared or vented gas, or gas delivered under a free gas clause, is deemed to be Produced And Saved. Leased Substances unavoidably lost during prudent operations are not considered Produced And Saved. Subject to SECTION 1.G.2., Leased Substances used to to support Lease or Unit operations are deemed to be Produced And Saved.

3. "Process," "Processed," and "Processing" mean:

A Leased Substance is separated into various products or otherwise treated or altered to enhance its value.

III. Conclusion

The process of "rethinking" the oil and gas lease involves much more than merely addressing the habendum, shut-in royalty, and royalty clauses. However, for our purposes today we have focused primarily upon the "production" requirement to demonstrate the market-sensitive nature of the oil and gas lease. The rethinking process should, in any event, go beyond the oil and gas lease. Since the oil and gas lease relationship has generated so much litigation, perhaps it is time to search for a new form of relationship, instead of merely new forms for expressing the traditional lease relationship. See Pierce, Rethinking the Oil and Gas Lease, 22 Tulsa L. J. 445 (1987) (suggesting that because of the conflicts inherent to the standard oil and gas lease relationship the lease should be abandoned altogether). However, realizing wholesale adoption of a new relationship is highly unlikely, I have chosen to focus on ways to improve upon the document used to create the "standard" oil and gas lease relationship.

SPEAKER INFORMATION

"OIL AND GAS LAW 1988"

Due Date: October 3, 1988

Please provide information about yourself that we may use with your written materials. We need no more than half a page. You should include (or emphasize) those facts and experiences which relate to the seminar. Please return this information to me by Oct. 3, 1988 .

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NAME

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David E. Pierce is an Associate Professor of Law, and Associate Director of the National Energy Law & Policy Institute, at the University of Tulsa College of Law, where he teaches Oil and Gas Law, Oil and Gas Contracts, Regulated Industries, and Environmental Law. Professor Pierce serves Of Counsel to the Tulsa-based law firm of Gable & Gotwals. Professor Pierce has also taught oil and gas law courses at the University of Texas School of Law, Washburn University School of Law, Indiana University School of Law, and the University of Houston Law Center. He has also served as an instructor in the Southwest Legal Foundation's Oil and Gas Law Short Course.

Prior to entering law teaching, Professor Pierce was an oil and gas attorney for Shell Oil Company in Houston, Texas and a Research Fellow at the University of Utah's Energy Law Center in Salt Lake City, Utah. Prior to that he practiced law in Kansas. Professor Pierce received his B.A. from Kansas State College of Pittsburg, his J.D. from Washburn University School of Law, and his LL.M. (Energy Law) from the University of Utah College of Law. Professor Pierce is the author of the Kansas Oil and Gas Handbook published by the Kansas Bar Association.