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RECENT DEVELOPMENT

EQUIPMENT DEPRECIATION CONSIDERED IN OIL AND GAS LEASE TERMINATION

OIL AND GAS LAW–DEPRECIATION: The Oklahoma Supreme Court held that depreciation of production equipment should be mandatorily included as an item of lifting expense in determining production in paying quantities necessary to maintain an oil and gas lease. No change however, was made in the overall method of determining when a lessee shall be deprived of his extended term estate. Any cessation in production must be weighed in light of compelling equitable circumstances. *Stewart v. Amerada Hess Corp.*, 604 P.2d 854 (Okla. 1979).

Should depreciation of production equipment be included in calculating lifting expenses for purposes of determining production in paying quantities as specified in the habendum clause of an oil and gas lease? Confronted with this question for the first time in 1979, the Oklahoma Supreme Court held, in *Stewart v. Amerada Hess Corp.*,[1] that such depreciation must be included in calculating production in paying quantities in Oklahoma. This decision, however, did not alter the overall method of determining when a lease should be terminated.

The habendum clause in an oil and gas lease specified the length of the primary term and the subsequent duration of the lessee's interest in the premises.[2] In most cases, the lease remains in force for as long a time after the primary lease as oil and gas is produced. In Oklahoma, "produced" denotes in law "production in paying quantities,"[3] which means that lessee must produce in quantities sufficient to yield a return, however small, in excess of lifting expenses even though well drilling and completion costs might never be repaid.[4] Accordingly, the items included in calculating lifting expenses can become critical in determining whether a well is producing in paying quantities. If depreciation of lifting equipment is included in calculating lifting expenses, a marginal well must produce more oil in order to continue production in paying quantities. If depreciation is

1. 604 P.2d 854 (Okla. 1979).
2. H. WILLIAMS & C. MEYERS, OIL & GAS LAW § 601.4 (Abr. ed. 1975).
3. 604 P.2d at 857.
4. *Id.*

excluded, less oil or gas need be produced to meet the requirement of a producing well, thereby maintaining the lease.

The Oklahoma Supreme Court addressed this issue on facts of two related cases. Amerada Hess Corporation acquired an oil and gas lease from the predecessor in title of the present owners, and assigned a portion of the lease to Union Texas Petroleum Company who sank a producing well. In 1973, the owners leased the same premises to the Rodman Corporation, who also sank a producing well. The owners brought an action to terminate Amerada's lease on the grounds that oil and gas no longer were being produced in paying quantities. Amerada then sued to eject Rodman from the premises and to secure a money judgment for the value of the oil and gas alleged to have been removed. The two cases were consolidated for trial.

The trial court did not include depreciation of production equipment in calculating lifting costs to determine production in paying quantities. Consequently, it upheld the superior lease rights of Amerada and rendered a money judgment against Rodman. The owners and Rodman appealed separately. Citing *Edwards v. Hardwick*[5] and *Whitaker v. Texaco,*[6] the Oklahoma Court of Appelas included depreciation of production equipment in the calculation of production in paying quantities and assumed that the modification in calculation would render Union's well operation unprofitable for those two years. Therefore, in two separate opinions, the trial court held as a matter of law that the Amerada lease had expired because the well had not been profitable in 1972 and 1973. On certiorari to the Oklahoma Supreme Court, the two cases again were consolidated.

Because this was a matter of first impression in Oklahoma, the court looked to the few cases from other jurisdictions that have addressed the issue. In deciding to include depreciation costs, the court rejected the reasoning of the Texas Supreme Court in *Clifton v. Koontz.*[7] The Texas court had upheld the trial court's exclusion of depreciation as an operating expense, reasoning that "if the rule were otherwise, many leases would be terminated and the lessees' incentive to drill decreased, regardless of the magnitude of the investment."[8]

The Oklahoma court viewed depreciation costs as reflecting the loss in value of lifting equipment by reason of its use to remove oil and gas from the formation. In support of this view, the court adopted

5. 350 P.2d 495 (Okla. 1965).
6. 283 F.2d 169 (10th Cir. 1960).
7. 160 Tex. 82, 325 S.W.2d 684 (1969).
8. *Id.*, 325 S.W.2d at 692.

the reasoning in *Skelly Oil Co. v. Archer*[9] and *Bales v. Delhi-Taylor Oil Corp.*[10] Those decisions held that production-related equipment has value that is reduced through its continued operation and should be included as a lifting expense.

In addition, the Oklahoma court stated that the base and the period of depreciation should be determined by reference to "currently prevailing accounting standards,"[11] but did not define or explain the accounting standards to be used.

The Oklahoma Supreme Court recognized that inclusion of depreciation in lifting expenses could have an adverse effect on operators whose wells produce little in excess of lifting expenses. To ameliorate the possible negative effects to the lessee of having these marginally producing wells turn into nonprofitable wells under the *Amerada* holding, the court cited former law regarding the method of determining when a lease would terminate. The court emphasized that "under no circumstances will cessation of production in paying quantities *ipso facto* deprive the lessee of his extended term estate."[12] Oklahoma law is well settled that each case must be viewed individually and the result must account for circumstances that surround cessation.[13]

The policy is reflected in an Oklahoma statute which clearly mandates that courts avoid the effect of forfeiture by giving due consideration to compelling equitable circumstances.[14] In the consolidated cases at bar, neither party had the opportunity to adduce proof of circumstances surrounding the cessation of profitable production, nor those factors which might afford compelling equitable consideration, either in favor of or against lease cancellation. The trial court did not consider depreciation a mandatory expense, so that no evidence was presented that the court of appeals could have relied on. Therefore, the supreme court vacated the court of appeals' opinions, reversed the judgments of the trial court, and remanded the cases. The trial court was directed to recalculate production in paying quantities, including depreciation of production equipment as a lift-

9. 163 Tex. 336, 356 S.W.2d 774 (1961).

10. 362 S.W.2d 388 (Tex. Civ. App. 1962).

11. Stewart v. Amerada Hess Corp., 604 P.2d 854, 857-58 (Okla. 1979).

12. *Id.*

13. *Id.*, citing Hunter v. Clarkson, 428 P.2d 210, 212 (Okla. 1967).

14. OKLA. STAT. ANN. tit. 23, § 2 (West 1955) states that whenever, by the terms of an obligation a party thereto incurs a forfeiture, or a loss in the value of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of grossly negligent, willful, or fraudulent breach of duty.

ing expense, and, if the well is thus unprofitable, to adduce proof of circumstances surrounding cessation of profitable production.

CONCLUSION

Although including depreciation of lifting equipment in calculating lifting expenses may force some operators to produce more oil and gas or forfeit their leases, there seem to be sufficient safeguards to prevent the widespread cessation of leaseholds due to lack of production in paying quantities as calculated under *Stewart v. Amerada Hess Corp.* Surrounding circumstances must be considered before a lease can be terminated.

The decision did not address several other questions: will changing the method of calculating production in paying quantities be sufficient surrounding circumstances to prevent immediate termination of a lease, and if so, how much time does an operator have to increase production to meet the standards of the new calculation? May an operator use one method of depreciation for tax purposes and another for calculating profitable production? These issues remain to be addressed in future disputes that undoubtedly will arise because of the new rule in Oklahoma.

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