OIL & GAS UPDATE: PA SUPREME COURT CLARIFIES 'PAYING QUANTITIES' IN GAS LEASES

The Pennsylvania Supreme Court has finally handed down its long-awaited decision in *W. T. Phillips Gas and Oil Company v. Jedlicka* ("*Jedlicka*"). In this case, the Court was asked to determine the meaning of "produced in paying quantities" as found in the habendum clause of many oil and gas leases.

Phillips was the successor lessee under a 1926 oil and gas lease of a tract which included Jedlicka's property. Although several wells have since been drilled, there was only one producing gas well on the property in 1959. Jedlicka alleged that because that well operated at a $40 loss in 1959, the lease had expired due to lack of production "in paying quantities." The parties agreed that the 1899 Supreme Court case of *Young v. Forest Oil Company* sets out the test for determining whether gas is produced "in paying quantities." However, the parties disagreed on the nature and scope of the *Young* test.

Jedlicka argued that under *Young*, the operator must both produce gas at a profit, and must also act in "good faith" in continuing to produce gas rather than surrendering the lease. Jedlicka basically argued that there should be an objective mathematical test of whether the operator realized profits in excess of the costs of production. Phillips argued *Young* did not require a mathematical test of profits, but only required the operator to act in good faith to produce gas - a more subjective test. Phillips argued the lease should not terminate simply because gas was not produced at a profit for a brief period of time, provided the operator believed in good faith the well would be profitable in the long term. The Pennsylvania Oil and Gas Association and the Independent Oil and Gas Association of Pennsylvania filed a joint "amicus" brief in support of Phillips' position.

The Pennsylvania Supreme Court reviewed numerous decisions from other states including Texas, Oklahoma and Kentucky, with regard to the test of "in paying quantities" which is utilized in those states. The Court found that a majority of other states apply a subjective approach similar to *Young*. These state courts look to a number of facts and circumstances, not just the math, to determine whether a prudent lessee would continue to operate the well for profit and not for speculation.

Based on *Young* and cases from other states, the *Jedlicka* Court ultimately held that:

> [i}f a well consistently pays a profit, however small, over operating expenses, it will be deemed to have produced in paying quantities. Where, however, production on a well has been marginal or sporadic, such that, over some period, the well's profits do not exceed its operating expenses, a determination of whether the well has produced in paying quantities requires a consideration of the operator's good faith judgment in maintaining operation of the well.

Thus, *Jedlicka* stands for the proposition that if production should become unprofitable for a time, the lease will not automatically terminate if the operator continues to operate the well in good faith and it later becomes profitable again. Or, otherwise stated, if an operator continues to operate wells under an applicable lease in good faith, his judgment as to whether they are producing in paying quantities will not be questioned by the court. As the Jedlicka Court noted, the *Young* test of the operator's good faith not only protects a lessor from speculation by the lessee, it protects the lessee from a lessor who tries to terminate a lease by exploiting a brief period of unprofitability. The Court specifically mentioned that

Jedlicka had received and accepted royalties since 1959 without ever trying to terminate the lease for lack of production in paying quantities.

In summary, the PA Supreme Court upheld the right of the gas lessee to continue to operate its well even during periods when production is marginal and operations are unprofitable, provided the lessee determines in good faith that it is prudent to continue to operate. The lessor was not permitted to void its existing lease in the hopes of signing a more lucrative Marcellus Shale lease. However, this decision does not mean an operator can keep a lease alive by continuing to operate when production is so marginal that not even a small profit is realized over a significant period of time. Hopefully *Jedlicka* has put to rest one method of attacking existing oil and gas leases.

Finally, *Jedlicka* may have significance in terms of the *Butler* case now on appeal to the PA Supreme Court. *Butler* is the case in which the Court was asked to reject the long-established *Dunham Rule*. Dunham was an 1882 case which held that oil and gas are not "minerals". Should the *Butler* Court rule that oil and gas are in fact "minerals", there is a possibility that title to some oil and gas leases could be adversely affected. Fortunately for the gas industry, *Jedlicka* demonstrates the Supreme Court has an appreciation for existing oil and gas case law, and may not be willing to disturb the *Dunham Rule.*