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A Roadmap for Commencement of Drilling Operations: Are We There Yet?

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For oil and gas lessees, the journey from signing a lease to having a producing well can be a long and arduous one. Countless turns, speedbumps and stops along the way can reasonably be expected. The habendum clause alone can quickly bring the lease to a screeching halt. Savings clauses have been inserted into modern fee oil and gas leases to prevent automatic termination of the lease while the lessee conducts certain operations. Discussed herein is the commencement of drilling operations savings clause which, in the majority of states, will permit a lease to be preserved after the expiration of the primary term without production if certain operations are being conducted.¹ However, even with this savings clause, lessees should be particularly wary of the roadblock approaching at the end of the primary term when determining whether drilling operations were properly commenced before expiration of the primary term. Well-constructed language in a fee oil and gas lease can allow continued operations even if the primary term has expired and the drill bit has not yet broken ground.²

Which lease provision is the commencement of drilling operation clause?

The following is an example of a commencement of drilling operations savings clause:

Notwithstanding anything in this lease contained to the contrary, it is expressly agreed that if Lessee shall commence drilling operations at any time while this lease is in force, this lease shall remain in force

Such clauses may include variations such as "commence operations to drill a well," "commence drilling or re-working operations," "commence or cause to be commenced the drilling of a test well," "commence the drilling of a well in search for oil or gas," "commence to drill a well," "if no well be commenced," "lessee is then engaged in drilling for oil or gas," "lessee is then engaged in drilling or reworking operations thereon," or "start drilling for oil."³ The question to be answered is what operations must a lessee commence to preserve the lease?⁴

What does commence mean?

Generally, the majority of the states hold that, unless otherwise provided for in the lease, actual drilling is not necessary in order to reach the threshold for commencement of operations. Courts have proved willing to find commencement of operations even when only "modest" preparations

for drilling have been made, such as erecting a part of an oil derrick and working on providing a water supply for drilling.⁵ Other preparatory activities such as obtaining drilling permit, staking and leveling the well location,⁶ building board roads to the drill site and a turn-around,⁷ moving tools and equipment onto the drill site, digging slush pits,⁸ and similar on-site activities have been held sufficient to be considered commencement of drilling operations.⁹ In order to reach the commencement of drilling operations threshold, a lessee should conduct as many on-site work activities as it can before the primary term expires. When determining adequate operations for commencement, courts favor active earthwork, clearing, construction, structure placement, etc., as opposed to gathering data, developing reports, obtaining permits, having meetings, and filing paperwork.

Courts have further required that such operations must be performed with the bona fide intention to proceed with good faith and diligence to the completion of the well.¹⁰ In a case where the preliminary commencement activities were performed by a company that had not yet acquired the rights to drill due to negotiations over the terms of a farmout agreement, the Wyoming Supreme Court held that the drilling operations were not done in good faith with the intent to complete insofar as the operator's rights were qualified and contingent and may not ever be realized.¹¹

When does the clause require actual drilling?

Some jurisdictions have differentiated between "commence operations" and "commence drilling operations." California, Kansas, and Montana courts have made such distinctions and held that "commence *drilling* operations" or similar language required the drill bit to penetrate the ground prior to the end of the primary term.¹² However, a Wyoming court held that there is no such distinction¹³ and "commence to drill a well" may be satisfied if preliminary commencement activities are not mere pretenses or a holding devise to retain the lease, if the acts are commenced and prosecuted with good faith and bona fide intention to drill and complete the well, and performed with diligence.¹⁴ Additionally, the Eighth Circuit Court of Appeals, applying North Dakota law, dismissed an argument that "engaged in drilling or reworking operations" meant "engaged in drilling" (meaning actual drilling was required) or "engaged in reworking operations;" rather, the court interpreted the clause as being engaged in "drilling operations" or "reworking operations."¹⁵

What about off-lease operations?

With the advent of off-lease surface locations for horizontal wells, the question arises as to whether operations on or from off-lease surface locations will qualify as commencement of drilling operations on the leased lands. There is currently little guidance to answer this question. As suggested by other authors, we recommend that new oil and gas lease forms and existing oil and gas leases be amended to include a provision similar to one of the following:

- (1) As used herein, the term Operations shall mean any activity conducted on or off the leased premises that is reasonably calculated to

obtain or restore production, including without limitations, (i) drilling or any act preparatory to drilling (such as obtaining permits, surveying a drill site, staking a drill site, building roads, clearing a drill site, or hauling equipment or supplies); (ii) reworking, plugging back, deepening, treating, stimulating, refitting, installing any artificial lift or production-enhancement equipment or technique; (iii) constructing facilities related to the production, treatment, transportation and marketing of substances produced from the leased premises; (iv) contracting for marketing services and sale of Oil and Gas Substances; and (v) construction of water disposal facilities and physical movement of water produced from the leased premises;¹⁶ or

(2) All operations conducted off the leased premises that are intended to result in the completion of, or restoration of production from, a producing interval on the leased premises or lands pooled or unitized therewith shall be considered operations conducted on the leased premises for purposes of extending and/or maintaining this lease in effect under any other paragraph or provision hereof.¹⁷

The lease, of course, would need to be further reviewed to confirm that the use of either of the above suggestions does not create any inconsistencies or confusion and all capital terms (if applicable) are appropriately defined.

What should I do?

In determining whether a lease has been extended beyond its primary term by the commencement of certain operations less than spudding the well, it is critical the specific language of the lease, the specific facts, and case law for the state in which the leased lands are located are reviewed. Even then, it may be difficult to conclusively determine whether the lessee's actions are sufficient absent actual penetration of the ground with a rig sufficient to reach a producing zone. Facing any uncertainty, if the lease and case law lack clear standards, the safest course of action, if possible, would be to get an extension of the lease.

¹Williams & Meyers, *Oil and Gas Law* § 617 at 297 (2012).

²This article is limited to fee oil and gas leases. As to federal oil and gas leases, actual drilling operations must be commenced prior to the expiration of the primary term – the bit must be “turning to the right” prior to 11:59 p.m. on the last day of the primary term. 71 Interior Dec. 263 (July 10, 1964). Site preparation and even moving a rig onsite do not qualify as actual drilling operations. 43 C.F.R. § 3100.0-5(g).

³Williams & Meyers, *supra* note 1, § 618.1 at 311.

⁴Not addressed herein is whether the commencement of drilling operations clause in the habendum clause of the lease also has the effect of being a continuous drilling clause, i.e., if the well is drilled as a dry hole, does the lessee have the right to commence a second well?

⁵Williams & Meyers, *supra* note 1, § 618.1 at 320.

⁶Petersen v. Robinson Oil & Gas Co., 356 S.W.2d 217 (Tex. App. 1962).

⁷Breaux v. Apache Oil Co., 240 So.2d 589 (La. App. 1970).

⁸Walton v. Zatoff, 125 N.W.2d 365 (Mich. 1964).

⁹See *Oelze v. Key Drilling, Inc.*, 135 Ill. App. 3d 6, 481 N.E.2d 801 (5th Dist. 1985) (a drilling rig was moved near the site, brush cleared and one of three pits were dug before the end of the primary term was found to be “commence operations for drilling”); *Johnson v. Yates Petroleum Corp.*, 981 P.2d 288 (N.M. Ct. App. 1999) (any activities in preparation for, or incidental to, drilling a well).

¹⁰See *Sword v. Rains*, 575 F.2d 810 (10th Cir. 1978); *Wold v. Zavanna, LLC*, 2013 WL 6858827 (D.N.D. Dec. 31, 2013); *Murphy v. Amoco Prod. Co.*, 590 F. Supp. 455 (D.N.D. 1984); *Stoltz, Wagner & Brown v. Duncan*, 417 F. Supp. 552 (W.D. Okla. 1976) (not required to cause the bit to pierce the earth before the end of the primary term, but must have the good faith intention to unqualifiedly drill the well, commence drilling the well on such date and pursued such drilling as a reasonably prudent operator); *Haddock v. McClendon*, 266 S.W.2d 74 (Ark. 1954); *Oelze v. Key Drilling, Inc.*, 135 Ill. App. 3d 6, 481 N.E.2d 801 (5th Dist. 1985); *Illinois Mid-Continent Co. V. Tennis*, 122 Ind. App. 17, 102 N.E. 2d 390 (1951) (lessee lacked good faith); *Flanigan v. Stern*, 265 S.W. 324 (Ky. 1924) (requiring after spudding reasonably diligence and bona fide effort); *Smirth v. Gypsy Oil Co.*, 265 P. 647 (Ok. 1928); *Bell v. Mitchell Energy Corp.*, 553 S.W.2d 626, 632 (Tex. App. 1977); *LeBar v. Haynie*, 552 P.2d 1107, 1111 (Wyo. 1976).

¹¹*True Oil Co. v. Gibson*, 392 P.2d 795 (Wyo. 1964).

¹²*Lewis v. Nance*, 20 Cal. App. 2d 71, 66 P.2d 708 (4th Dist. 1937); *Hall v. JFW, Inc.* 893 P.2d 837 (Kan. 1995); *Soldberg v. Sunburst Oil & Gas Co.*, 235 P. 761 (Mont. 1925) (“commence drilling operations for oil”).

¹³*Fast v. Whitney*, 187 P. 192 (Wyo. 1920) (“commences drilling”).

¹⁴*LeBar v. Haynie*, 552 P.2d 1007 (Wyo. 1976) (“commence to drill a well”); *True Oil Co. v. Gibson*, 392 P.2d 795 (Wyo. 1964).

¹⁵*Anderson v. Hess*, 733 F. Supp. 2d 1100, 1106-07 (D.N.D. 2010) *aff'd* 649 F.3d 891, 898 (8th Cir. 2011) (insofar as the lessor conceded that the lessee was engaged in drilling operations before the primary term expired, the court did not address whether the lessee's preparatory activities were satisfactory to constitute drilling operations.). See also *Wold v. Zavanna, LLC*, 2013 WL 6858827 (D.N.D. Dec. 31, 2013) (granting summary judgement in favor of the lessee based on *Anderson v. Hess* and finding “drilling or reworking operations” had been commenced when lessee obtained all drilling approvals, engaged in actual on-site construction, hauling of equipment and materials on site, installing culverts and cattle guards, and digging reserve pit prior to the expiration of the primary term and finding that the lessee had capability to drill the well and good faith intent to complete the well with reasonably diligence).

¹⁶Milam Randolph Pharo & Gregory R. Danielson, “The Perfect Oil and Gas Lease: Why Bother!,” 50 Rocky Mt. Min. L. Inst. 19-1, 19-18 (2004).

¹⁷John W. Broomes, “Spinning Straw Into Gold: Refining and Redefining Lease Provisions for the Realities of Resources Play Operations,” 57 Rocky Mt. Min. L. Inst. 26-1, 26-12 (2011).

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