

CALENDAR ITEM

03

A	35	07/12/13 PRC 735.1 PRC 3120.1 PRC 3242.1 PRC 3314.1 J. Planck J. Rader
S	10	

CONSIDER APPROVAL OF AN ASSIGNMENT OF A PORTION OF OIL AND GAS LEASE NOS. PRC 735.1, PRC 3120.1, PRC 3242.1 AND PRC 3314.1 FROM VENOCO, INC. TO VENOCO ENERGY PARTNERS OPERATING, LLC (VEPO), SANTA BARBARA AND VENTURA COUNTIES

ASSIGNOR:

Venoco, Inc.
6267 Carpinteria Ave., Suite 100
Carpinteria, CA 93013

ASSIGNEE:

Venoco Energy Partners Operating, LLC
6267 Carpinteria Ave., Suite 100
Carpinteria, CA 93013

AREA, LAND TYPE, AND LOCATION:

Venoco, Inc. proposes to assign 22% of its interests in State Oil and Gas Leases Nos. PRC 735.1 and 3314.1 (offshore Ventura County), as well as 22% of its interests in nine specified well bores that are on lands governed by State Oil and Gas Leases Nos. PRC 3120.1 and 3242.1 (offshore Santa Barbara County). The interests assigned would be working interests; i.e., the assignee would participate in both profits and production costs, but would have no role to play in actual production. Venoco, Inc. would be the sole party having an operating interest in the lease; i.e., it would be the entity having responsibility for all operations.

BACKGROUND:

Venoco, Inc. is currently the sole lessee and operator of four subject leases under consideration. All of these Leases were issued between June 30, 1952,

CALENDAR ITEM NO. **03** (CONT'D)

and July 2, 1965, and, through a number of assignments and conveyances, Venoco, Inc. is the current lessee of record.

Venoco, Inc. now proposes to create a business structure that would entail the creation of a master limited partnership (the MLP) called Venoco Energy Partners, L.P. (VEPLP) and, as a subsidiary to that limited partnership, a limited liability company (LLC) called Venoco Energy Partners Operating, LLC (VEPO). VEPO would be the assignee under the proposal here considered. As provided by each of the four leases, the assignments cannot take place unless and until approved by the Commission.

Under a limited partnership, a limited partner has no liability for the obligations of the partnership except to the extent that each limited partner's share of the assets of the partnership may be used to satisfy obligations of the partnership. The only partner that does not have such limited liability is the general partner. In this case, the general partner would be another limited liability company, Venoco Energy Partners GP, LLC (VEPGP), which would hold a 2% interest in VEPLP. VEPGP would be a wholly owned subsidiary of Venoco, Inc. Because VEPGP is a limited liability company, any obligations it has could be met only by looking to the assets of the company itself.

Transfer of a 22% interest in nine specified well bores within PRC Nos. 3120.1 and 3242.2 would effectively result in a transfer of approximately 20% of total current production from the two leases. There are now 16 wells in production on the two leases, all drilled from Platform Holly. The nine wells in question, though, account for nearly 90% of the total production from the two leases. That percentage may change in the future, though, if production of other Platform Holly wells is increased. Venoco, Inc.'s stated reason for assigning interests solely in the specified well bores is simplicity in management and marketing. The nine wells produce in fairly steady quantities. Returns are expected to be reasonably reliable under the standards of oil and gas wells, and, since the limited partners in VEPO's parent, the master limited partnership, would share in the costs of production, reliable wells with steady production would entail fairly predictable costs. According to Venoco, Inc., no redrills are expected on those nine wells in the near future, so investors would face less uncertainty as to anticipated production.

The practical effect of this structure is that VEPO would receive 22% of the production from PRC Nos. 735.1 and 3314.1 and, subject to some potential fluctuation in the future, approximately 20% of the production from PRC Nos. 3120.1 and 3242.1. After deductions for costs, revenue earned from that share of

CALENDAR ITEM NO. **03** (CONT'D)

production would pass through VEPO to VEPLP and then on to that entity's partners. The assets within VEPO would be the rights to the specified share of production.

Venoco, Inc. would continue as owner of all other interests in the four leases. Platform Holly, the onshore drilling and production sites associated with PRC 735.1 and PRC 3314.1, and all associated pipelines and other production, processing and transportation equipment and facilities would remain the property and responsibility of Venoco, Inc., which would also be responsible for all operations.

Liability for obligations under the four leases would also be affected by the assignment. An incremental increase in risk to the state would result from the assignment, but it would be largely contained by insurance and bonding.

Under sections 8670.56.5 *et seq.* of the Government Code (Gov. C.), both Venoco, Inc. and VEPO would in all likelihood be held absolutely liable for all damages arising from any oil spill from any of the four leases. Because VEPO's assets are limited, though, Venoco, Inc. would be seen as the entity best able to meet those obligations. Consequently, and as required under the Gov. C. sections 8670.31.51 *et seq.*, Venoco carries in excess of \$250 million in insurance. Insofar as the fields developed from the four leases in question are all mature and do not currently flow without artificial lift (thereby presenting minimal risk of blowout as would arise from new drilling into an undeveloped field), it is highly unlikely, though technically possible, that damages from a spill from the leases could result in damages exceeding the available insurance. Also, insofar as all oil from Platform Holly is now transported to market by pipeline, rather than by barge, the potential for a large offshore spill is further reduced.

Contractual obligations would to a large extent be covered by bonds. The existing bond covering PRC 735.1 and 3314.1, in Ventura County, is considered adequate, currently set at \$2 million. The bond for the leases in Santa Barbara County would be increased. For PRC 3120.1 and PRC 3242.1, the current bond amount, required by statute, is in dispute. Venoco, Inc. now maintains a bond in the amount of \$7.5 million. Venoco, Inc. has agreed to raise the amount of the bond to \$10 million within 30 days of approval of the proposed assignment and then to increase the amount by \$4 million each year for the following five years until the total amount of the bond reaches \$30 million in 2018. On January 1, 2025, and on each tenth anniversary of that date thereafter for so long as the Leases remain in effect, the bond shall be adjusted to reflect the parties' best reasonable estimate of Venoco's abandonment obligations for Platform Holly.

CALENDAR ITEM NO. 03 (CONT'D)

The manner in which the federal government calculates expected abandonment costs of platforms in federal waters would be considered an appropriate and relevant illustration as to how such should be calculated. This bond would also be extended to cover Oil and Gas Lease No. PRC 421.1, a relatively small lease Venoco holds adjacent to PRC 3120.1.

Although insurance and bonding would largely cover all likely obligations under the leases, some residual incremental risk would remain from the proposed assignment. Venoco, Inc. has significant assets beyond just the production reserves it holds. It has the production, processing and transportation equipment and facilities necessary to run an oil and gas company. VEPO, with a substantial minority interest in the four state leases, would hold essentially nothing but the rights to production. As that production is realized and sold, earnings would simply pass through to the partners in VEPO's parent MLP. Each limited partner in the MLP would have no obligation to cover any liabilities except to the extent that the limited partner's share of the MLP may be used to cover such liabilities. As is explained above, the incremental risk is limited, given the insurance, statutory oil spill liability and bonding; but some residual risk to the state remains.

The benefit to the state of the proposed assignment would arise from the potential for enhanced returns from the four leases. Venoco, Inc. has generally been a responsible operator during the period it has held the subject leases. Production from the four leases has increased 256% from 1,012,430 barrels in 2010 to 1,603,224 barrels in 2012 to an annual estimate of 2,597,000 barrels for 2013, based upon the production from the first four months. Consequently, the state has seen the royalty revenues from these leases increase by approximately 426%, from \$9,648,075 in 2010 to \$25,466,193 in 2012 to an annual estimate of \$41,109,030 for 2013. While, under the terms of the proposed restructure, Venoco, Inc. cannot guarantee that funds earned from the sale of shares in the limited partnership will be used specifically on lease operations, the sale would put Venoco, Inc. in a better financial position to do so. It may generally be considered in the interests of the state to accommodate efforts by entities with which the state does business in acquiring more capital, provided it does not jeopardize other interests of the state.

As part of its restructuring, Venoco, Inc. also intends to assign to VEPO interests in leases it holds in federal waters. To that end, it has received approval for the assignment from the Bureau of Ocean Energy Management (BOEM). Additionally, VEPLP will file with the Securities and Exchange Commission (SEC) a registration statement relating to the public offering and sale of partnership units in VEPLP. That registration statement must be declared effective by the

CALENDAR ITEM NO. **03** (CONT'D)

SEC under the Securities Act of 1933, as amended, before VEPLP may sell its units to the public. Staff therefore recommends that, if the Commission were to approve the proposed assignments, it condition approval upon subsequent effectiveness of the SEC registration statement. The approval would not become effective unless and until the SEC declares the registration statement effective.

STATUTORY AND OTHER REFERENCES:

- A. Section 4 of State Oil and Gas Leases Nos. PRC 735.1, 3120.1, 3242.1 and 3314.1
- B. Government Code sections 8670.1 *et seq.*
- C. Public Resources Code sections 6801 *et seq.*

OTHER PERTINENT INFORMATION

- 1. The staff recommends that the Commission find that the subject lease assignment does not have a potential for resulting in either a direct or a reasonably foreseeable indirect physical change in the environment, and is, therefore, not a project in accordance with the California Environmental Quality Act (CEQA).

Authority: Public Resources Code section 21065 and California Code of Regulations, Title 14, sections 15060, subdivision (c)(3), and 15378..

- 2. Venoco, Inc. has agree to provide a new bond in the amount of \$10 million, within 30 days after Commission approval of the proposed assignment, covering all obligations of Venoco Inc. and VEPO under Lease Nos. PRC 3120.1, PRC 3242.1 and PRC 421.1. Venoco, Inc. and VEPO would also agree that the bond will be increased by \$4 million on the anniversary date of approval of the assignment by the Commission until the amount of the bond reaches \$30 million in 2018. The parties also agree that, on January 1, 2025, and on each tenth anniversary of that date thereafter for so long as the Leases remain in effect, the bond shall be adjusted to reflect the parties' best reasonable estimate of Venoco, Inc.'s abandonment obligations for Platform Holly. The manner in which the federal government calculates expected abandonment costs of platforms in federal waters would be considered an appropriate and relevant illustration as to how such should be calculated.
- 3. Venoco, Inc. has agreed to enter into a Reimbursement Agreement for an amount of up to \$100,000 annually, adjusted 5% each year, for the staff's actual costs associated with the management of PRC 421.1, 3120.1 and

CALENDAR ITEM NO. 03 (CONT'D)

3242.1. A reimbursement agreement covering management costs associated with PRC 735.1 and 3314.1 is already in place.

4. Venoco, Inc. has agreed to pay all royalties due the state for production from all four leases on behalf of both itself and VEPO.
5. Any approval given by the Commission for the proposed assignment would be subject effectiveness of the registration statement to be filed by VEPLP with the SEC relating to the public offering and sale of partnership units in VEPLP. The approval would not become effective unless and until the SEC declares the registration statement effective.

EXHIBIT:

- A. Location Map

RECOMMENDED ACTION:

It is recommended that the Commission:

CEQA FINDING:

Find that the subject lease assignment is not subject to the requirements of CEQA pursuant to California Code of Regulations, Title 14, section 15060 subdivision (c)(3), because the activity is not a project as defined by Public Resources Code section 21065 and California Code of Regulations, Title 14, section 15378.

AUTHORIZATION:

1. Consent to the assignment of a 22% working interest in State Oil and Gas Leases Nos. PRC 735.1 and 3314.1 and a 22% working interest in well bores identified as Nos. 11, 12, 14 and 16 on Lease No. PRC 3120.1 and in well bores identified as Nos. 4, 7, 9, 12, and 18 on Lease No. PRC 3242.1, with the assignee to be bound by all the terms and conditions of the Leases; subject to the following conditions:
 - a. The bond covering obligations under Leases Nos. PRC 3120.1, PRC 3242.1 and PRC 421.1 is increased to \$10 million within 30 days following Commission approval of the assignment and then would be further increased by \$4 million each year for the following five years until the total amount of the bond reaches \$30 million in 2018. On January 1, 2015, and on each ten-year anniversary

CALENDAR ITEM NO. 03 (CONT'D)

thereafter, the bond amount would be readjusted to reflect Venoco, Inc.'s and the state's best reasonable estimate of Venoco's abandonment obligations. The manner in which the federal government calculates expected abandonment costs of platforms in federal waters would be considered an appropriate and relevant illustration as to how such should be calculated.

- b. Venoco agrees to enter into a Reimbursement Agreement for an amount of up to \$100,000 annually, adjusted 5% each year, for the staff's actual costs associated with the management of these leases.
 - c. The registration statement to be filed with the SEC by VEPLP under the Securities Act of 1933, as amended (Securities Act), relating to the public offering and sale of partnership units in VEPLP becomes effective under the Securities Act.
 - d. Venoco agrees to indemnify, defend and hold harmless the State, the Commission and its agents, officer and employees from and against any and all claims, demands, damages, obligations, causes of action, proceedings, awards, fines, judgments, penalties, awards, liabilities, losses, costs and expenses (including without limitation reasonable attorneys' fees, court costs, expert and witness fees, and other reasonable costs and fees of litigation) of every kind and nature whatsoever asserted by investors in MLP units and arising or alleged to have arisen, in whole or in part, out of or in connection with the Commission's approval of the assignment by Venoco of a portion of the Leases to VEPO
- 2. Approve an amendment to PRCs 3120.1, 3242.1 and 421.1 regarding the security requirements for faithful performance of the terms and conditions of the leases, in substantially the form on file in the office of the Commission.
 - 3. Approve an amendment to the indemnity provision (Paragraph 13) of PRCs 3120.1 and 3242.1, to include the language substantially in the form as contained in 1.d., above.

CALENDAR ITEM NO. **03** (CONT'D)

4. Authorize the Executive Officer or her designee to execute any documents necessary to implement this assignment and lease amendment.

EXHIBIT A

PRC 735.1
PRC 3314.1

