A Report of
The Joint Committee on Public Domain

THE ADMINISTRATION OF STATE OWNED TIDELANDS

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JOHN A. NEJEDLY, VICE CHAIRMAN

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Bill Bond
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Charles Warren
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Senate:
Ralph C. Dills
Joseph M. Kennick
James R. Mills

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BY

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Joint Committee on Public Domain

KENNETH CORY
CHAIRMAN

JOHN A. NEJEDLY
VICE CHAIRMAN

August 15, 1974

The Honorable President of the Senate
The Honorable Speaker of the Assembly
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Dear Members:

The Legislature at its 1971 session instructed the Joint Committee on Public Domain, among other things, to:

> "...ascertain, study, and analyze all facts relating to the best use of the revenues which now or in the future accrue from the development of the tide and submerged lands held in trust, to meet the financial needs of the State of California...
>
> The committee is further authorized and directed to review public land management policies..."

Again in the 1973-74 session of the State Legislature ACR 63 reenforced its demands in the following language:

> "...In addition to any duties heretofore or hereafter assigned to the Joint Legislative Committee on Public Domain, the committee shall determine whether the state is receiving a fair price for the state's mineral deposits."

To accomplish these tasks, the Joint Committee on Public Domain had to examine first the operation of the regulatory agency into whose purview these determinations fell, thus this report on the "Administration of State-owned Tidelands".

The first of several fact finding reports on the assigned subject is hereby respectfully submitted.

Sincerely,

KENNETH CORY

KC:Nm

P R E F A C E

This report will show that the administration of State oil resources by the State Lands Commission and the State Lands Division has been wholly unacceptable by any standards.

Furthermore, the report will conclusively demonstrate that the Commission and its staff are totally lacking in the expertise necessary to develop and administer the State's oil leases.

Failure to use ordinary prudence in marketing the State's crude oil has unnecessarily caused the loss of millions of dollars in State revenues and has slowed the development of a most valuable resource.

CONCLUSIONS

1. The State Lands Commission has ignored evidence that the price California receives for State-owned crude oil is too low (pp 9-10).

2. The Commission hired a consulting firm with virtually no expertise in crude oil marketing, and a frequent consultant to major oil companies, to study crude oil pricing (pp 11,13).

3. The Commission uncritically accepted the conclusion of the consultant's report which was contradicted by the data contained in the report (pp 11, 13).

4. The Commission delayed the sell-off of available crude oil from the Long Beach Unit for three years with consequent direct loss of income to the State of as much as $2 million (pp 9, 13-14, 16).

5. In the sell-off the Commission chose a bid factor which had the minimum economic benefit to the State, and the maximum benefit to the major oil companies (p 15).

6. In a number of its decisions, the Commission has identified itself with major oil companies, rather than the segment of the industry of which it is a part -- the independent producer (p 18).

7. Major oil companies use exchange practices to hide the real value of crude oil. The resulting low posted prices, accepted by the Commission, cause considerable financial loss to the State and all other independent producers (pp 17-20).

8. In evaluating the exchanges, the Commission accepted the findings of the major oil companies' own auditor (p 20).

9. The Commission has failed to exercise its contractual right to inspect major oil company records to determine what the oil is really worth (p 22).

10. The Commission abdicated to the major oil companies its right to determine the fair market price the State would be paid for its crude oil under numerous offshore contracts (pp 23-25).

11. Among the 41 people in the Division's Long Beach Office, there is not a single person with the expertise to determine whether the State is receiving a fair price (pp 26-27).

12. According to reports prepared by the Office of the Auditor General for the Joint Committee on Public Domain:

    a) The Commission reversed, without factual findings, a previous decision not to enter into a disadvantageous land exchange in Newport Bay with a large private landholder (pp 28-30);

    b) Entered into a boundary line agreement proposed by a private beachfront property owner at Coronado, when a spot check by State engineers disclosed that as much as 75 feet of State-owned land would be given away by the State under the agreement (pp 30-31);

    c) Allowed major oil companies in Santa Barbara and Huntington Beach $1.9 million in transportation allowances that were not contractually required (pp 32-33);

d) Refused to consider the suggestions of the Joint Legislative Audit Committee to take royalty oil in kind and trade it to refineries in return for gasoline and other products needed by State and local governmental agencies (pp 33-34);

e) Loses $2 million per year by failing to charge a reasonable rate for rental of harbor terminal facilities (pp 34-35).

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INTRODUCTION

The Legislature at its 1971 session instructed the Joint Committee on Public Domain, among other things, to:

> "...ascertain, study, and analyze all facts relating to the best use of the revenues which now or in the future accrue from the development of the tide and submerged lands held in trust, to meet the financial needs of the State of California...
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To accomplish these tasks the Joint Committee on Public Domain, hereafter referred to as the Committee, had to examine the operation of the regulatory agency into whose purview these determinations fell, thus this report on the "Administration of State-owned Tidelands".

The Committee has carefully gathered and thoughtfully reviewed the available data on the administration of State-owned lands including: hearings with major oil companies, resulting in subpoenaing of documents by a Subcommittee; hearings at which independent oil companies which produce crude oil urged us to continue our investigation of major oil company pricing practices; hearings and staff interviews with present and former members of State Lands Division staff plus other informal staff interviews with the production, refining and marketing segments of the industry.

Finally, the Committee staff itself has attracted members with considerable personal expertise in these areas of the oil industry.

This portion of the report of the Committee will limit itself to the data concerning the Administration of these Tidelands.

I STATE LANDS COMMISSION: ORGANIZATION AND FUNCTION

The State Lands Commission, hereafter referred to as the Commission, is the statutory organization which controls State owned lands. Although it has other areas of responsibility, such as classification of State lands as to uses, regulations for land protection and evaluation for environmental purposes, by far the most important function of the Commission is to oversee the production of crude oil from the State tidelands.

The Commission consists of three persons: the Controller (as Chairman), the Lieutenant Governor, and a designee of the Governor (at the present time, the Director of the Department of Finance). There is no requirement that any of these persons have any expertise in crude oil production and marketing or in any other area of land use planning and management.

The actual work of the Commission is done by the State Lands Division, hereafter referred to as the Division. The Division has a large staff of people who have some expertise in the production of crude oil. They report to the Executive Director of the Division, who is also Executive Officer of the Commission.

This report will discuss the Commission's management of the State-owned oil resources. It will examine in detail the management of the State's crude oil production and will discuss other areas in the purview of the Commission more briefly.

II THE OIL ACTIVITIES OF THE STATE LANDS COMMISSION

The State of California is a large producer of crude oil. In 1973, 192,609 barrels per day of crude oil were produced from the tidelands. No single company produces this much oil in California.

The Division is responsible for protecting the State's interests under two different kinds of crude oil production agreements. The first, and most important, relates to the Long Beach Unit, part of the Wilmington Oil Field. The Wilmington Field is the second largest producing oil field in the United States. The most productive segment of the Field is the Long Beach Unit, in which the State has the largest interest. The Unit consists of 93 tracts. The largest is known as Tract 1, for which the City of Long Beach is trustee for the State. There is a somewhat smaller offshore tract, known as Tract 2, which the State controls directly. There are, additionally, 91 quite small tracts onshore which are owned by a variety of private landholders including the City of Long Beach in its incorporated capacity. Under the unitization documents[1] the City of Long Beach is the unit operator of the 93 tracts, but it contracts out the actual daily operation to a field contractor.

The Long Beach Unit is an extraordinary reservoir of crude oil. Before Tracts 1 and 2 were opened to drilling, it was apparent

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1 In order to provide the most efficient development of an oil field with diverse ownership, it is useful to have a single operator run the field, as if it were in single ownership.

This permits maximum recovery of the deposit with minimum capital and operating costs. Each of the owners of an interest in the thus created unit receives a predetermined share of the net oil and gas produced.

The unitization documents provide for this single operator.

that there was a substantial quantity of oil offshore and there was no point in sharing with the oil companies a risk which did not exist. Therefore, the City of Long Beach ran core holes on the field to determine how much oil was there and of what quality. The contract to produce and to buy the oil from the Unit was then let on a net profits bidding arrangement.

The relationship between the City of Long Beach and the State of California with respect to Tract 1 is that of trustee and beneficiary. The City has various rights regarding the collection of revenues and the regulation of drilling in Tract 1. It maintains a limited amount of the money collected, passing on the remainder to the State. The State has certain independent rights and, in addition, the Commission has general oversight over the City of Long Beach. The State maintains direct control of Tract 2, as limited by the Unitization Agreement.

One of the most troublesome aspects of negotiating a contract for the sale of oil from Tract 1 was the pricing provision. The capability of the major oil companies to manipulate prices was so obvious that special pricing provisions were drawn. The contract was, therefore, written to provide for the State to receive the highest of several alternative pricing indices. These are:

1) The arithmetical average of prices posted in the Wilmington Field by continuing purchasers, those who purchase more than three thousand barrels a day;

2) The arithmetical average of prices posted in certain named fields, the Wilmington Field, the Signal Hill Field, Huntington Beach and Inglewood. The only

continuing purchasers in the field or named fields are the integrated major oil companies[2]. Only four of these post prices in California -- Standard Oil of California, Union Oil Company, Mobil Oil Company, and Atlantic Richfield Company. Except during temporary periods of price adjustment, their posted prices have always been nearly identical within each field;

3) The weighted average of prices paid by substantial purchasers, people who purchase an average of 300 barrels a day for each of the preceding 12 months, for oil in the field; and

4) The weighted average of prices paid by substantial purchasers of oil in the named fields.

The payments to the State are computed on the highest of the four preceding prices.

As further protection against price manipulation there is a "most favored nation" clause. By this, if any of the contractors

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2 The term "major oil company" refers to the large integrated oil companies involved in all phases of the industry, i.e., production, refining, transportation and marketing. In this report, the major oil companies in California are considered to be Standard Oil of California, Arco, Texaco, Exxon, Union, Mobil, Shell, Phillips and Gulf Oil Corporation.

The independents, on the other hand, refer to those non-integrated companies generally much smaller in size and which are usually principally involved in only one phase of the industry.

(or in the case of joint venture contractors, any one of the joint venture partners) acquires oil in the field from any other person, either by purchase or exchange of oil, the price which the contractor must pay for State-owned oil must be that higher price for each day on which such acquisition of oil is made.

To help determine which of the pricing provisions should apply, the contract stipulates that each contractor shall furnish to the City or the State, upon request, a valuation schedule covering all gravities of oil in the field and an accurate and current list of all purchases and sales of oil by the contractor and by persons having an interest in the contractor. Additionally, the contractor and each person comprising a contractor, is required to permit the authorized representatives of the City and State to examine "relevant books, ledgers, accounts, correspondence, memoranda, and other records in the possession of or under the control of such contractor and persons comprising any contractor ... for the purpose of obtaining and confirming information relevant to or necessary to the implementation of evaluation provisions".

Finally, as further protection against manipulation of prices in the field, and to allow access to the State's oil to small independent oil companies without the resources to engage in bidding on the contract, there is a provision whereby, on the direction of the State, the field contractor must offer for sale 12-1/2% of the oil allocated to Tract 1. The terms of the bidding are fixed by the State. No bid may be accepted unless it is equal to or greater than the amount per barrel at which the field contractor accounts for like oil, computed as provided in the first four standards, excluding the "most favored nation" clause.

The situation is quite different in the other crude oil-producing tidelands. There are numerous tracts in the Huntington Beach area and around Oxnard, Ventura and Santa Barbara. These are all leased under the Cunningham-Shell Statute, a statute which provides the basic form for State leases. In these, the State receives a standard royalty of approximately 16-2/3% of the crude oil produced (occasionally increased depending on the rate at which oil is taken from the lands). It may take this royalty either in cash, at fair market value of the oil, or in kind.

One of the most important clauses in almost all Cunningham-Shell leases is the exclusive right of the State to determine the fair market value of the crude oil. Any reasonable interpretation of the contract would prohibit the Division or Commission from arbitrarily setting a fair market price completely unrelated to the realities of the marketplace. Whenever there is evidence that the fair market price is higher than the posted price in the nearest field, however, the Commission should order the oil companies to pay for the royalty oil at that higher level.

A. Activities Relating to the Long Beach Unit

1) Initiation of the Tract 1 Sell-off:

As noted above, with respect to the Tract 1 contract, the Division has the right to order a sell-off of 12-1/2% of the State's share of the Long Beach Unit production. This makes some oil available to the small independent refining companies and is a check on the market to ensure that the State receives a fair price for its crude oil.

The sell-offs could have taken place when the field went into production in 1965. The Division did nothing with respect to the sell-off until 1971. On November 8, 9 and 10, bids were received on three increments from Tract 1: one of about 6,800 barrels per day, a second of about 3,900 barrels per day, and one of about 1,500 barrels per day. The winning bids on the three increments were 15.629¢ and 21.4¢, respectively, per barrel higher than the price the THUMS[3] companies were paying.

The Committee finds that the sell-offs should have taken place no later than 1968, although they could have been accomplished when the field went into production in 1965. By 1968 there was ample evidence that a test for the fairness of the prices being paid by the major companies was necessary.

In mid-1967, the independent crude oil producers of the State became concerned about the low prices of crude oil in California and commissioned a study by the independent consulting firm of The Ben Holt Co. The Ben Holt Co. sent the study to its sponsors in December of 1967, detailing evidence that California crude oil was underpriced. Although this study was not officially transmitted to the Commission until July of 1968, it is apparent that there was concern in the industry about low pricing as early as mid-1967.

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3 THUMS is an acronym for Texaco, Humble (now Exxon), Union, Mobil and Shell, the consortium which won the contract to operate the Unit and take 80% of the production from Tract 1. The remainder of Tract 1 went 10% to a joint venture of Allied Chemicals and Pauley Petroleum and 10% to a joint venture of Atlantic Richfield and Standard Oil Company of California.

On January 19, 1968, an independent petroleum consultant sent a letter to Assemblyman Charles Warren detailing the fact that crude oil in the range of the type produced from the Long Beach Unit was priced significantly lower in California than it was in the rest of the country. This letter was transmitted to Mr. Jay Shavelson of the Attorney General's office, who acts as attorney for the Commission. In his response to Mr. Warren on February 19, 1968, Shavelson pointed out that not only was the Commission considering a study of the matter, but "the State Lands Division ... has under consideration <u>testing the local market</u> in the area of the Wilmington oil field <u>by offering some portion of the Long Beach tidelands oil for purchase on the open market</u> ..." (emphasis supplied)

The Committee finds that the Commission was derelict in not testing the market directly by the best means available -- selling off the oil to see what it would bring on the open market.

Instead, the Commission, in March of 1968, commissioned a study by the international petroleum consulting firm, DeGolyer & MacNaughton. DeGolyer & MacNaughton is a highly respected firm in the fields of reservoir engineering and the economics of production. However, they were hired to make a study on refining values and market values of crude oil, areas beyond their expertise.

How DeGolyer & MacNaughton came to be chosen for this job is curious. They were retained by the Commission in 1964 to do a study on the necessary staffing of the Division's section overseeing the production of the Long Beach Unit.

They came highly recommended to the Commission for this task by 24 sources. Of these, 12 were either chief executives of major oil companies or their paid lobbyists; 9 were executives of insurance companies which have major oil company executives on their boards of directors; 3 were federal government officials, two who became major oil company executives on their retirement, including one who is DeGolyer's son-in-law.

It is noteworthy that the independent segment of the market was not consulted.

The Committee cannot find where the Commission launched an inquiry to determine either their expertise in crude oil marketing or their lack of bias.

Although DeGolyer & MacNaughton were commissioned to analyze the fairness of the price paid by the major oil companies to the State, they could well have been involved in a conflict of interest between the State and their principal clients -- the major oil companies.

The DeGolyer & MacNaughton Report concluded that there was a direct relationship between the prices in California of residual fuel oil and the heavy crude oils which contained a large proportion of residual fuel oil. It pointed out that because there was a glut on the market of residual fuel oil at the time the study was prepared, the price of crude oils heavy in that product would have to be low. They anticipated that the price would go up when the glut ended.

The Committee finds DeGolyer & MacNaughton's conclusion, that the price of heavy crude oil was directly related to the price of residual fuel oil, is completely unsupported by the data contained in the report. An analysis of the charts on which DeGolyer & MacNaughton based its conclusion demonstrates only a fair relationship between the prices of heavy crude oil and residual fuel oil prior to 1958 (See Insert, Pages 1 & 3). Subsequent to mid-1958, the relationship is effectively zero. (See Insert Pages 2 & 3). During the 10 years between September 1958 and preparation of the report in 1968, the price of crude oil changed a total of four times over a range of 20¢; the price of residual fuel oil fluctuated nine times over a range of $1.25. The Commission has stated that, "The Division staff was fully satisfied with the DeGolyer & MacNaughton report ..."

In the years subsequent to 1968, the price of residual fuel oil skyrocketed and the price of crude oil increased very little, contrary to the prediction of DeGolyer & MacNaughton. The Committee notes that even at the time the report was submitted, data from the report showed it to be inaccurate.

Another reason set forth by the Commission why it did not offer the crude oil for sale was that there was a surplus of crude oil in the industry. This conclusion was based on the DeGolyer & MacNaughton Report, on responses from the major oil companies to a Commission questionnaire, and on an "informal survey", the results of which were not provided by the Division to the Committee.

The Committee sought information directly from the independent refiners of the State regarding their crude oil position between 1968 and 1973. The respondents indicated that they were running a total of 44,000 barrels per day less than capacity. The amount of oil which could have been put up for sale under the Tract 1 agreement totaled about 12,000 barrels a day. The

EXPLANATION OF FIGURES 1 AND 2

The solid 45° line, starting from the lower left corner of Figure 1, shows the location of the observations if the prices for crude oil and for heavy fuel oil were identical at all times.

The actual relationship between the two series of prices for the earlier period, 1951 to 1957, is shown by the broken line. There was direct correlation, as the line slopes upward to the right. The correlation is not very high, however, as shown by the way the dots (representing the prices for each oil when either price changed) scatter above and below the regression line. The coefficient of correlation is 0.590. For perfect correlation (the 45° line), the coefficient would be 1; for a shotgun pattern, with the dots evenly distributed over the whole chart, the coefficient would be 0. A coefficient of 0.590 as here is a fairly thin basis for claiming that the price of crude oil is necessarily tied to the price of heavy fuel oil.

Figure 2 shows that for the period from 1958 to the date of the DeGolyer and MacNaughton report, there was substantially no correlation. A perfectly flat line shows zero correlation. No matter what happened to the price of heavy fuel oil, ranging between $1.75 and $2.80, the price of crude oil only changed a few cents in the entire 10 year period and showed no change at all from mid-1963 to the end of 1967. The coefficient of correlation is 0.135, so low as to be absolutely useless as a device for predicting the price of crude oil.

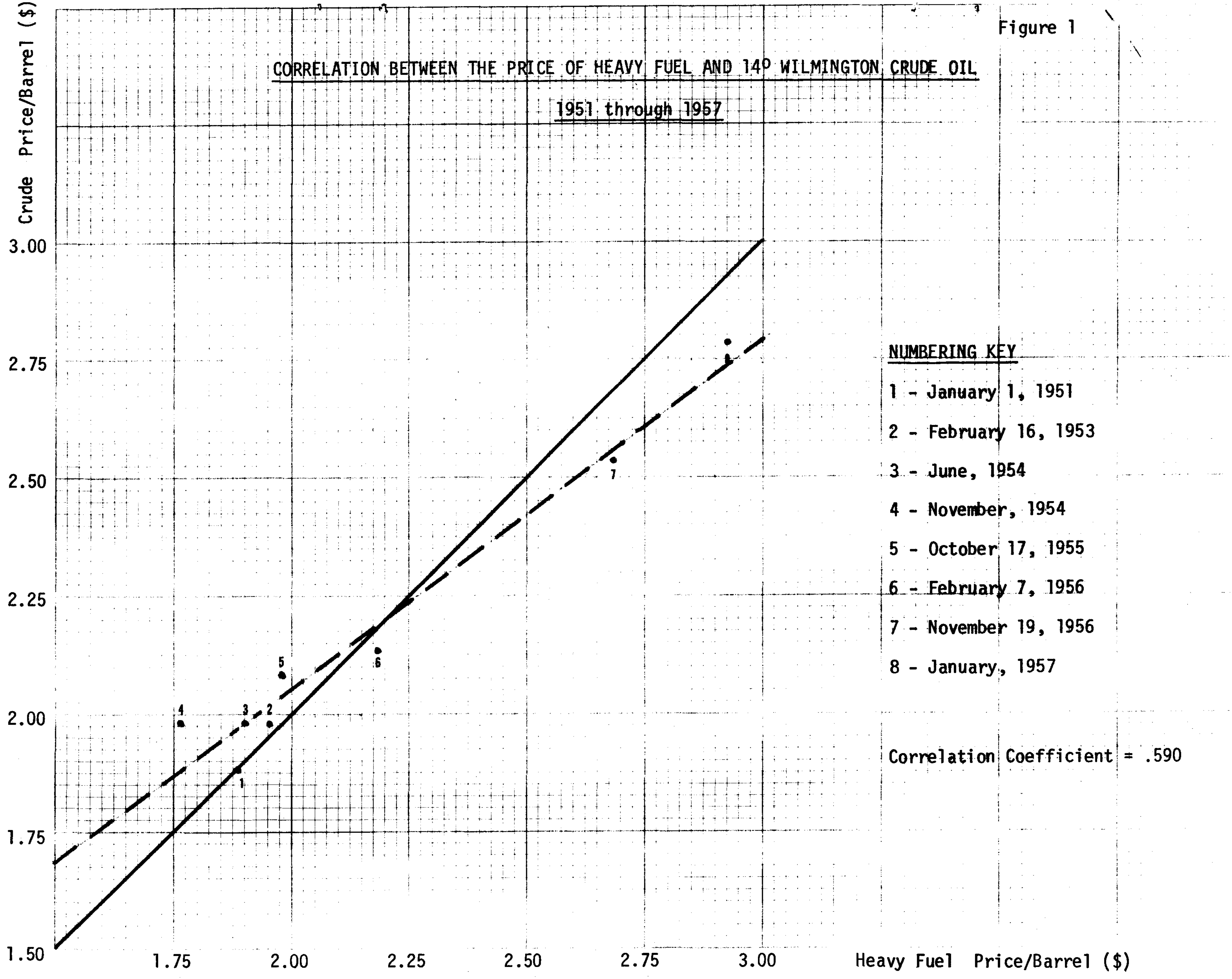
Table 1

CHANGES OF 14^{o} WILMINGTON CRUDE OIL AND HEAVY FUEL PRICES

1951 - 1967

	Crude Oil		Heavy Fuel	
	Date	Price/Barrel	Date	Price/Barrel
1	January, 1951	$1.88	January, 1951	$1.878
2	February 16, 1953	1.98	February 16, 1953	1.951
3			June, 1954	1.900
4			November, 1954	1.768
5	October 17, 1955	2.08	October 17, 1955	1.979
6	February 7, 1956	2.13	February 7, 1956	2.180
7	November 19, 1956	2.53	November 19, 1956	2.689
8	January 17, 1957	2.78	January, 1957	2.926
9			April, 1958	3.45
10	April 14, 1958	2.58	April 14, 1958	3.054
11	June 24, 1958	2.38	June 24, 1958	3.050
12	September 30, 1958	1.88	September 30, 1958	2.80
13	September 11, 1959	1.78		
14			July, 1960	2.15
15	September 24, 1960	1.88	September 24, 1960	2.271
16	January 22, 1962	1.98	January 22, 1962	3.00
17	June 1, 1963	1.88	June 1, 1963	2.075
18			December, 1963	1.875
19			October, 1964	1.975
20			January, 1965	2.050
21			May, 1967	1.850
22			June, 1967	1.750

SOURCE: DeGolyer and MacNaughton, Report on Crude Oil Pricing in California



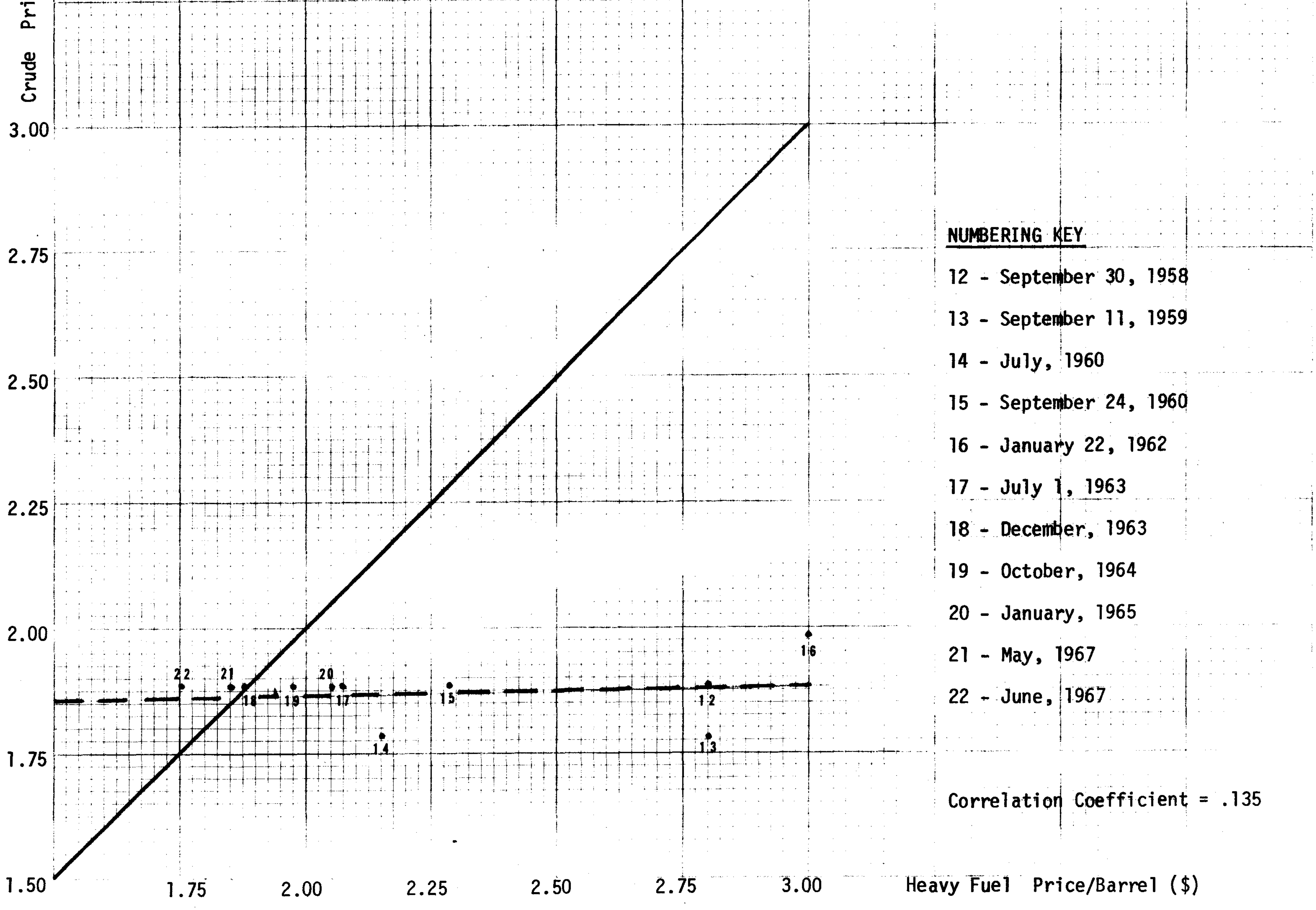
CORRELATION BETWEEN THE PRICE OF HEAVY FUEL AND 14° WILMINGTON CRUDE OIL
1951 through 1957
Crude Price/Barrel ($)
3.00
2.75
2.50
2.25
2.00
1.75
1.50
1.75
2.00
2.25
2.50
2.75
3.00
Heavy Fuel Price/Barrel ($)
1
2
3
4
5
6
7
8
NUMBERING KEY
1 - January 1, 1951
2 - February 16, 1953
3 - June, 1954
4 - November, 1954
5 - October 17, 1955
6 - February 7, 1956
7 - November 19, 1956
8 - January, 1957
Correlation Coefficient = .590

Figure 1

Figure 2

CORRELATION BETWEEN THE PRICE OF HEAVY FUEL AND 14° WILMINGTON CRUDE OIL

1958 through 1967



independent segment of the industry could have easily absorbed the sell-off and still been running at significantly less than its capacity.

In its defense, the Commission has said that if the sell-offs had taken place earlier, they would have brought significantly lower prices than did later sales and that the State would have lost money by not receiving the higher prices.

Had the Commission written sell-off contracts in 1968 on the same three year basis as it sold the oil in 1971, the oil would have been up for sale again in 1971. During the three year delay, the State was effectively disposing of the "sell-off" oil to the major oil companies at prices lower than they might have brought on the open market. Even if the winning bid had been only 1¢ per barrel over posted, in the three years this would have meant $146,179 in additional income to the State for this oil. If the winning bids had been the more realistic figure of 15.629¢ over posted, the lowest winning bid in 1971, the benefit to the State would have been $2,284,623.

The Committee finds that the history of the Tract 1 sell-off is one of extreme neglect on the part of the Commission. The Commission failed:

1) To retain an appropriate consulting firm, both in terms of expertise and in terms of lack of bias to study the market;
2) To read the resulting study closely enough to tell that its conclusions didn't agree with its data;
3) To initiate a sell-off when all evidence indicated that one was needed.

The Committee finds that these three things in combination have cost the State millions of dollars. The cost to the State was not only direct loss of revenues, but also the indirect costs in other tideland oil production revenues. Furthermore, one of the reasons for the sell-off provisions was to provide for the independent refiners to participate in the program and prevent monopolization of the industry by the major oil companies. This benefit was lost by not invoking the sell-off provisions.

2) The Terms of the Sell-off Contract:

The terms of the THUMS sell-off were of great importance to the State. The Tract 1 contract is very intricate, and choosing the proper bid factor has a significant effect on the income of the State. The Committee finds that the Commission chose a standard which resulted in the minimum increase in revenue to the State.

As noted above, the contractors on Tract 1 are required to pay the State on the basis of the highest of four alternative provisions and the "most favored nation" clause. One of the standards is the weighted average of prices paid by substantial purchasers for "purchases of oil" in the Wilmington Field. To prevent a perpetual spiral of prices caused by feeding back sell-off prices into the formula for evaluating the price the contractor must pay Long Beach on behalf of the State, the attorney for the Commission determined that the bid price must be excluded from the definition of "purchases of oil". This perpetual price spiral could have been avoided, however, in another way. If the bid called for a firm price, the contractor's price would be adjusted upward once, and the bidder's price would remain at the firm level, ending the cycle.

A second requirement of the bidding was that the bid price had to be equal to or higher than the price the contractors were paying under the four alternative standards, excluding the "most favored nation" clause.

As far as the Commission could see they had four possible bidding alternatives (see Transcript of Proceedings, California State Lands Commission, Sell-off Hearing - Tract No. 1, Long Beach Unit, April 20, 1971, at 6-12). These were: "X" dollars per barrel over the price the contractors paid to the City on the State's behalf; 100% + X% of the price the THUMS companies paid the City; a cash bonus in addition to the price the contractors pay the City; and a flat price, provided it was not less than the price the contractors pay the City. Referring to these standards, the Division's attorney stated that whichever standard was chosen, the bid price would not qualify as a "purchase of oil" and would not change the price the contractors had to pay (Transcript at 8).

The Committee finds this is a misreading of the contract. The last of the four standards must be defined as a purchase of oil. The bid price, being firm, would not be interdependent with the contractors' price, and thus <u>would</u> qualify as a purchase of oil.

None of the potential bidders who appeared at the hearing favored the firm-price bid, but the Commission gave no real consideration to any bid factor other than the one the bidders did favor, i.e., "X" dollars over the contractors' price. Had the Commission given due consideration to the interests of the State and not misinterpreted the contract, it could have maximized the State revenues by choosing a standard which would increase the price of all the oil from the field rather than just the amount which was sold off.

3) Subsequent Sell-offs:

There are three other tracts in the Long Beach area from which the State had the power to sell-off crude oil, Tract 2, a part of the Long Beach Unit, and two older fields known as Parcel A and L.B.O.D. Additionally, the State had the right to take oil in kind from approximately 80 leases in the Huntington Beach area and Santa Barbara area.

The Committee finds that delays in the implementation of these sell-offs were very costly.

Given the success of the Tract 1 sell-off, there should have been an immediate move to sell-off the remaining available oil. Parcel A, L.B.O.D. and Tract 2 had a total of 5,130 barrels per day available for sell-off. However, the next sell-offs, from L.B.O.D. and Parcel A, did not take place until a year after the Tract 1 sell-off, on November 6, 1972.

Further, as of the hearing of the Committee on February 26 and 27, 1973, nothing had been done by the Commission to prepare for sell-offs of the Tract 2 oil or of any of the other offshore royalty oil. The latter group of sell-offs eventually took place on August 23, September 26 and September 28, 1973. The results of these sell-offs brought bids as much as $1.27 per barrel higher than the posted price.

The sell-offs might not have brought so high a price had they taken place earlier. However, between the date of the bidding and the acceptance of the bids by the Commission, the Cost of Living Council prohibited the State from selling crude oil at this higher price. Thus, the State has received nothing from these sell-offs. Had the sell-offs taken place timely, the State would have had substantial increases in revenue. The delay brought the State into the "Phase IV" prohibitions, and prevented the State from getting the increase.

4) Inspection and Analysis of Major Oil Company Documents:

The Tract 1 contract is very specific as to the right of the State not only to demand lists of purchases and sales from the contractors and schedules of prices, but to permit the State:

> "to examine relevant books, ledgers, accounts, correspondence, memoranda, and other records in the possession of, or under the control of (the) Contractor ... for the purpose of obtaining and confirming information relevant to or necessary for the implementation of the valuation provisions contained in this Article 9 ..."

Among the provisions of Article 9 is the "most favored nation" clause, which, as noted above, requires the contractors to pay the State the highest value for oil acquired in the Wilmington Field, whether the acquisition is by sale or exchange. The word "exchange" is crucial.

The Committee has found there is an unwritten rule among the major oil companies in the industry that crude oil transactions take place only at posted prices, except for exchanges.

Evidence before the Committee indicates that the majors exchange crude oil because the refinery value of crude oil is not represented by the posted price.

The majors are able to purchase oil at a price so low they can make exhorbitant profits in the refinery. It is unlikely they would sell this crude at this depressed price they bought it for, and give up the refinery profit. So when they have to sell this crude because they lack transportation facilities or temporary refinery capacity, but a competitor is equipped to handle the previously purchased crude, they insist on purchasing another crude from the competitors at the same depressed prices in return.

Many of the decisions made by the Commission indicate that they cannot distinguish between independent producers and major oil companies. The State, like all independent producers, must make its profits in crude oil sales. The majors can shift their profits among production, refining and marketing. At present, the biggest profits in the industry in California are being made in refining, at the expense of production. This puts the State and other independent producers in a posture antithetical to the major oil companies.

The City of Long Beach has recognized this by joining the Independent Oil and Gas Producers of California, a trade organization of those in the same boat as the State, and is a member of the board of directors.

The Committee finds that the exchange system is perpetuating this inequity and is at the heart of the undervaluation of California's tidelands oil.

The 3-cut exchange[4] completely sidesteps the money marketplace. It is extremely difficult to evaluate each cut. The State rarely has a cut analysis of the crude it is selling, even if it could evaluate each cut. This collection of hidden data makes the 3-cut exchange an excellent device for masking the disparity between the posted price and the "price" at which the majors deal with each other.

The Committee concludes that the inclusion of the exchange provision in the "most favored nation" clause was a recognition of the reality that the oil companies barter oil on a different economic basis than they do when they simply purchase oil for cash.

The "most favored nation" clause enables the Division to receive for its own Tract 1 crude oil the value of oils which any of the contractors in Tract 1 gives up when acquiring Wilmington crude. Further, the information provision allows the State to examine all books and records which reflect the negotiations and evaluations of the oil companies when involved in 3-cut exchanges

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4 Crude oil is a broad mixture of hydro-carbons which boil at various temperatures. Of the three basic mixtures, Cut One, which boils at temperatures below 400° is essentially gasoline and jet fuel components.

Cut Two, which boils between 400° and 650° is essentially diesel and other jet fuel components.

Cut Three is essentially fuel oil, boiling above 650°.

In a Three-Cut exchange transaction, each side exchanges several crudes with the other, trying to keep in balance the number of barrels, and the number of barrels of each "cut".

with THUMS crude or in posted price exchanges for the same crudes.

In a letter to the Chairman of the Commission, the Committee asked what efforts the Commission had made to implement the inspection clause of the contract, particularly with respect to exchange agreements, and what else had been done to analyze 3-cut exchanges.

The Commission responded, first by stating:

> "It should be noted that an audit by Price-Waterhouse (sic) and Company, dated November 17, 1967, ordered by the State, reviewed compliance with Article 9. In commenting on Article 9(c), which encompasses exchange agreements, the audit noted that: 'There have been no known price variations which would necessitate adjustment.' "

What is surprising to the Committee is not the conclusion that Price-Waterhouse reached, but the fact that the Commission hired the regular auditor for Standard Oil Company of California, Exxon, and Shell Oil Company and other major oil companies. It requires the utmost naivete to assume that the regular auditor of these companies would expose the intricacies of exchange accounting to a one-time client who would use the information against three of its largest steady clients.

The Commission response continues:

> "Until 1972, the Division was satisfied that the bulk of oil from Named Fields being transferred by exchange agreements was in reference to posted prices. With the advent of the crude oil sell-offs, effective July 1, 1972, exchange agreements became of moment

"because small companies were now directly involved, with the possibility that bonuses or premiums were part of the consideration. Accordingly, 1972 exchange agreements and transactions were audited in the following year by the Division. On March 27, 1973, the Acting Executive Officer wrote to the eight companies comprising the contractors of Tract 1 and Tract 2, Long Beach Unit, demanding that they furnish information on acquisitions of oil in the Wilmington Oil Field by exchange ..."

The Committee has not found any evidence to verify either of the first two sentences in this statement. First, based on years of experience in the industry by several of the Committee staff (one of whom had extensive experience in exchange accounting) and on a review of the documents the Committee subpoenaed from oil companies, there have been extensive 3-cut exchanges of Wilmington crude oil since the Long Beach Unit went into production in 1965. These exchanges have no reference to the posted price.

Second, 3-cut exchanges take place only among majors. Exchanges with reference to posted price take place mostly with independents, and independents do not have the benefits of 3-cut exchanges.

The next two sentences of the statement omit some important information. In the Hearing of the Joint Committee on Public Domain on February 26-27, 1973, the Chairman inquired about the Division's efforts to analyze crude oil exchanges and was told:

"Really, I don't think we're staffed up to go in to try and investigate all exchange agreements. We can "perhaps pursue this particular problem. This is quite a job we're taking on to try and evaluate crude oil exchanges. This is a very complex thing."

Thus, if the Commission had not urged it, the inquiry would not have been made.

The Division has not received all the basic data necessary to the evaluation of the crude oil. They have asked the major oil companies for these data and the major oil companies have refused to give it to them.

There are two important points here. One is that the inspection clauses were not utilized until the past year because the Commission failed to realize their value. Second, is that when the information to be obtained was brought to the attention of the Division by the Committee, neither the Commission or Division had the talent or expertise to evaluate the 3-cut exchanges.

The Committee charges the Commission was remiss in not maintaining an aggressive posture and actively pursuing the documents by way of court order if necessary.

B. <u>Activities Relating to Other Offshore Crude Oil Production</u>

Cunningham-Shell Contracts have completely different pricing and royalty provisions than the Long Beach Unit contracts. The Santa Barbara area and the Huntington Beach area offshore oil contracts generally call for a minimum of 16-2/3% royalty. The royalty may, at the option of the State, be taken in cash or in kind. If taken in cash, the amount which the producing company must pay is the fair market price "as determined by the State".

The statutes under which the oil-bearing tidelands are leased restrict the discretion of the Commission. About five of the older leases limit the discretion of the Commission to prevent it from over-charging the oil companies. About 55 more recent leases also limit the discretion of the Commission to prevent it from under-charging the oil companies, and thereby cheating the State of its due. The Committee finds the activity of the Commission indicates the wisdom of this latter legislative policy. Finally, about 20 leases, under certain conditions, limit the Commission's discretion both ways.

A rational program of "determining the fair market value" of crude oil in the offshore areas would have included a program of sell-offs of royalty oil at regular intervals, from dispersed areas of production, and including various qualities of crude oil. The sell-offs would be spaced in time to account for changing market values. The results of the sell-offs would be used to adjust the fair market value of royalties being paid in cash. Contracts placing a ceiling on the fair market price should be used as sell-off oil.

In making its determination of fair market price, the Division has always adopted the posted price. It has never made any market studies to determine if the fair market price may be something other than the price posted in the field.

It is obvious to the Committee that when the technologically least sophisticated refining companies bid higher than the posted prices, the Commission should have questioned its old standard. This was not done. The Chairman of the Committee, in a letter of September 19, 1973, called the attention of the Chairman of the Commission to this pricing provision, urging him to "set the current market price of crude oil at a price which reflects the recent bids for the State 'in kind' royalty oil and demand a payment from the lessees for this higher amount". By that point the bids had reached 77¢ per barrel over posted, and would soon reach $1.27 over posted. The Chairman of the Commission refused to take appropriate action.

In a response of May 14, 1974 to various questions propounded by the Chairman of the Committee, the Commission proposed three reasons why it did not apply the bid prices to the other State offshore oil. First, it claimed that it should only use data from the same or nearest producing field to determine the fair market price. This limited the application of bid prices to the Huntington Beach area. The Committee finds this to be a completely arbitrary decision.

The Huntington Beach and Long Beach fields are only separated by 10 miles and are included in the same schedule of posted prices. Distance factors are accounted for in the posting. The distance from the Long Beach Unit is no valid excuse for the Commission to abdicate its duty to use the Long Beach bid price to determine the fair market price of Huntington Beach oil.

Second, the Commission concluded that the range of bids did not indicate a great disparity between posted prices and market value. The highest winning bid on the Tract 1 sell-off was 21.4¢ over the posted price; the lowest winning bid was 15.6¢ over. The price of Wilmington 18^{o} crude, the type which was being sold off by the Tract 1 bidding, was $2.61 per barrel on the date that the sell-off was held. The winning bids ranged from roughly 6% to 8% higher than the current market price.

It is worth noting that the Commission dismissed this as "representing the particular needs of the bidders". The bidders in this case were the least technically advanced firms in the industry[5]. Thus, the oil was worth less to them than to the major companies which set the posted price. How can a fair market price be set if not by the price purchasers are willing to pay, considering their own "particular needs"?

Finally, the Division justified their failure to raise prices in the Huntington Beach area on the grounds that at least one of the leases had a provision preventing the State from setting a <u>higher</u> price than was being offered by major oil companies in the area for similar types of oil.

The Committee notes that this one lease does not justify the Commission's failure to take advantage of the available increase in prices with respect to the remaining Huntington Beach leases.

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5 The value of the products a refinery can make from heavy crude oil is dependent on the degree of technology incorporated in the refinery. A simple refinery may consist of a simple distillation unit, which can do nothing more than "fractionate" the crude oil, i.e., separate it into components of various boiling points. If the crude oil being run is heavy, the products will have a large proportion of the less valuable, heavy fuel oil. A more advanced refinery,on the other hand, will have a variety of units for "cracking" the heavy products into lighter, more valuable products. It can, in effect, turn cheap fuel oil into high-priced gasoline at the ratio of 5 barrels of gasoline for every 4 barrels of fuel oil. Very few of the independent refiners in California have substantial cracking equipment; all of the majors have. Most of the crude oil in the State, including the Tract 1 oil, is very heavy.

Unquestionably, the Commission was derelict in this area of its responsibilities. There were decades during which a test of the market could have been made, but wasn't. Even when the Tract 1 sell-offs took place, three years later than they should have, the Commission became interested only after a decision of the Cost of Living Council had made action impossible.

C. <u>The Staffing of the State Lands Division</u>:

The City of Long Beach, operator of the East Wilmington Field, had a total staff of 58 people in its Department of Oil Properties in June 1974. These people are responsible for supervising the entire City and State-owned oil fields in the Long Beach area tidelands, including 933 producing tidelands wells, 322 onshore wells, and 296 water injection wells (as of June 30, 1973). This constitutes a decline from the peak of 64 staff positions.

The Division has authorization for 41 people in the Long Beach office. Their function is to check on the Long Beach staff activities relating to the State's share of the tidelands.

The real work load on the Division's staff comes during the development phase of an oil field. The critical decisions are those involved in proving the field, outlining it, testing for depth, and selecting the best method of producing it. Those decisions were made several years ago, and substantially carried out more than four years ago.

By June 30, 1973, THUMS had drilled at least 509 producing wells. Of these, 404 had been completed by June 1969, and the other 105 were completed by June 1973. The Annual Report of the Division of Oil Properties for 1969-1970 said:

"most of the drilling activity during the year was in the Long Beach Unit where 72 wells were completed. Over 90 per cent of total planned wells have been drilled in this new field, where development started just five years ago."

Fiscal 1969-1970 was also the year of peak production from the field; production has declined about one-fourth since then.

With the policy decided, the heavy drilling program completed except for 6-16 wells a year (as compared with nearly 200 a year in the peak years) and the actual production going down, the Committee is critical of the Division maintaining a ratio of two of its staff to check on the work of three of the Long Beach City staff - especially when some of the Long Beach activity is not within the purview of the State.

The Committee is even more critical of the fact that there is no one on the Commission's Long Beach staff who has any expertise in the vital areas of crude oil marketing, crude oil exchange accounting and analysis, or refinery valuation. The vast amounts of crude oil the State sells mandate that expertise is necessary in guiding the choices and timing of sell-offs, and in analyzing the exchange data which the Division should have to ensure that the State is getting its due under the contracts.

There are the classical signs of a bureaucracy. The professionals in the Division answer only to the Commission. The members of the Commission do not know whether the professionals are doing an adequate job in their fields, and whether they are posing as experts in related fields (such as crude oil marketing, exchange accounting or refinery valuations). Only the Commission judges the Division and the Commission refuses to be judged.

III REPORTS ON THE STATE LANDS COMMISSION PREPARED BY THE AUDITOR GENERAL

In 1971, the Chairman of the Committee issued several requests to the Chairman of the Joint Legislative Audit Committee for audits of the State Lands Division. His requests have generated five management reports. These reports, each of which point to failures and inadequacies of the Division, are entitled:

A) State Lands Division - Review of Upper Newport Bay Proposed Land Exchange;

B) Review of State Title to Certain Beach Property in Coronado, California;

C) State Lands Commission - Report on Transportation Allowances and in Calculating State Oil Royalties - Santa Barbara and Huntington Beach Areas;

D) Report on State Crude Oil Royalties; and

E) Review of State Tidelands Leases Executed by the State Lands Commission with Oil Companies and Public Utilities.

We will deal with each of the above reports in summary manner. Copies of the full text of each of the reports can be obtained from the Office of Vincent Thomas, Chairman of the Joint Legislative Audit Committee.

A. Review of Upper Newport Bay Proposed Land Exchange - Completed 8-1972

A clear example of the failure of the Commission to take appropriate, direct affirmative action is provided by the sequence of events relating to the Upper Newport Bay Land Exchange between a large private land company and Orange County.

The proposed land exchange was intended to pave the way for a land company development of the Upper Newport Bay into a residential harbor oriented toward private waterfront residences. This land exchange involved a trade of public trust tidelands and submerged lands in the upper bay for private uplands and three islands owned by the company.

Under the applicable statutes, before such an exchange can be consummated, the Commission must find that:

a) The State lands which are to be exchanged are no longer useful for the trust purposes of navigation, commerce, and fishing;

b) The lands to be received in exchange for tidelands are at least of equal value to that to be given up;

c) The exchange is in the best interest of the State.

In accepting the written recommendations of the Division staff, the Commission found that "the ultimate outcome would be a distinct loss in value when measured in the scale of Statewide public interest".

"1. It cannot be established clearly that all the lands which are to be exchanged are no longer useful for navigation, commerce, and fishing.'

"2. Realignment and relocation of the public waterways as proposed would diminish the greater public use which could be developed otherwise.

"3. Removing the burden of easement and enlarging the (company) lands into usable private areas would be a purely local benefit which would convert public waterways into a captive waterway primarily for the use of the private residential boat owners who would occupy the created area and dominate the bay.

"4. The project would create commercial areas completely privately controlled which could add to the preponderant private domination of the bay."

Thirteen months later, on September 25, 1967, a new Commission approved the same exchange without rebutting or overcoming the original, explicit objections cited earlier in denying the exchange.

B. Review of State Title to Certain Beach Property in Coronado, California

The actions of the Division and the Commission regarding State title to beach property in Coronado show complete disregard for the best interests of the State.

The boundary line agreement, requested by the private owners, was approved in the near record time of two months and without the benefit of a complete survey by State engineers. A spot check by State engineers of the property owners' survey of the mean high tide line found discrepancies of up to seventy-five (75) feet and still a complete survey was not done.

The mean high tide, drawn by the property owners and approved by the Division, fell exactly on the line beyond which the property owners could not build any major structures. It seems highly unlikely that these two lines would correspond exactly. It is much more likely that the line agreed to by the Division was a line to accommodate the owners.

This boundary line agreement, detrimental to the public interests, was agreed to by the Division when several other options were open. Among the available options were litigation to determine the line of State ownership, litigation to preserve the public's right to use the entire beach, and trying to reach an agreement on a line which provided the public with an adequate beach for recreational purposes.

A private citizen, William J. O'Connell, outraged by the boundary line agreement, filed a suit in San Diego Superior Court against the owners in an effort to secure public access to the beach. The Division, again ignoring the best interests of the public, declined to assist in the suit or to request the Attorney General to do so.

The negotiated settlement of the suit was somewhat helpful to the public. However, the Commission's help would have put O'Connell in a stronger bargaining position. The negotiated settlement reflected not only the strength of the legal position of each side, but also power and financial ability to pursue the case.

A special counsel hired by the City of Coronado, indicated to the City that a suit to recover public access of the beach could be won. If the City had sued and won title to the land, it would have belonged to the State. However, the Attorney General declined to enter the suit on behalf of the State.

While the City of Coronado was negotiating with the owners for more public beach, the Commission refused to allow the City to see a report detailing the problems in the Coronado beach area.

More vigorous and thorough action on the part of the Commission and the Division, or at least cooperation with those who were fighting for the people's right to the beach, could have resulted in a settlement much more favorable to the public.

C. State Lands Commission Report on Transportation Allowances and in Calculating State Oil Royalties: Santa Barbara and Huntington Beach Areas

This report implies that the Commission has failed to maximize the State's revenue from royalty oil by allowing the oil companies holding leases in the Santa Barbara and Huntington Beach areas to deduct transportation costs in valuing State royalty oil. No specific provision is made in the Public Resources Code for transportation allowances. Moreover, prior to allowing the transportation costs in individual cases, the Division failed to make any meaningful studies of appropriate costs. This seems to be an indication of the non-critical attitude of the Division, the lack of staff expertise, and the willingness of the Commission to be led by the oil companies whose interests are obviously not concurrent with the State's interests.

According to the contracts used by the Commission, when the State takes its royalty oil in cash rather than in kind, "the market price at the well shall be determined by the State", and "the market price determined by the State shall not be less than the highest price in the nearest field in the State of California at which oil of like gravity and quality is being sold in substantial quantities..."

Public Resources Code Section 6827 requires that the State's royalty be based on the "current market price at the well" less a dehydration and treatment allowance. No mention is made of transportation allowances.

The Monterey Oil Company constructed the first offshore drilling island on State tidelands and asked the State to assume the cost of transporting the oil onshore. In 1956, following review by the Executive Officer of the Division and an Assistant Attorney General, the first transportation allowance was approved for this company. Subsequent leases provided for a transportation allowance. Apparently, no further review has been made as to the soundness of the original decision to allow transportation allowances.

There are now a total of thirteen (13) leases where a transportation allowance is being taken. $1.9 million in transportation allowances have been deducted from State royalty oil payments through December 31, 1971.

Of that $1.9 million, $944,000 were attributed to lease P.R.C. 2207, where a $.1988 per barrel transportation allowance was used in calculating the cash value of the royalty oil. There is, however, no breakdown in the Division files of the specific costs nor indication of the estimated production rate used in determining this particular rate. For other leases, there is a similar failure to justify the specific costs that were allowed. Also, for a number of leases, certain allowances were recommended in reports while other, higher rates were actually granted.

D. Report on State Crude Oil Royalties

This report by the Joint Legislative Audit Committee recommended a study be made to "determine the feasibility of contracting directly with a refinery for converting the State crude oil into gasoline and other products needed by the State and local governmental agencies".

The Commission has done nothing positive to implement this proposal, but rather has opposed legislative attempts to implementation.

The Committee calls attention to the fact that the Division is on record opposing both AB 2684 (December 5, 1973) and AB 3488 (March 20, 1974). These bills proposed two different methods of retaining State control of oil owned by the State or produced from State-owned lands, for refining under contract to the State and for subsequent allocation to public agencies to maintain essential public services.

E. Review of State Tidelands Leases Executed by the State Lands Commission with Oil Companies and Public Utilities

State revenues would increase by more than $2 million annually if the Commission would charge public utility and oil companies a reasonable price for the use of marine terminal facilities.

Lease rates are set by the Commission at about six per cent (6%) of the appraised value of the land. The appraised value is arbitrarily set by the Division and does not reflect the value of the facilities to the lessee.

Although the Commission has been increasing revenue by raising renewal rates, the State's income is still incredibly low. The top State lease brings in $900.32 per acre annually while the Port of Long Beach has a lease with Atlantic Richfield that brings more than $7,500 per acre annually to Long Beach.

Long Beach charges 3/4 cents per barrel on all petroleum and related products loaded or unloaded through private pipelines in their port. The Port of Los Angeles charges 1/2 cent per barrel. A recommendation by the Auditor General that the Commission charge one cent per barrel has brought no action from the Commission.

The $200,000 annually the State currently earns could be doubled within the first two years and total a minimum of $2.4 million annually once all leases have been renewed, if the Commission adopted the Auditor General's recommendation to charge one cent per barrel.

An additional failure by the Commission has cost the State hundreds of thousands of dollars. The Commission does not charge interest on retroactive lease payments. While negotiations on a lease agreement may last for years, no interest is charged by the Commission once an agreement is reached.

Continued inaction by the Commission will result in additional losses of revenue and prolong the period needed to correct the situation because lease renewals are continually being negotiated.

IV COMMITTEE COMMENTS ON REPORTS PREPARED BY AUDITOR GENERAL

In the audits performed by the Joint Legislative Audit Committee, we see a continual application of nonfeasance in the administration of the Division and, in some cases, such as the Upper Newport Land Exchange, a reversal of the stated position without any explanation as to the reasons for the reversal.

V FUTURE REPORTS IN THIS SERIES

This is the first in a series of reports on the development of oil in the California Tidelands. It, as well as those to follow, contains specific findings of fact with respect to the mal-administration of California's crude oil resources and other activities of the State Lands Commission.

The tens of thousands of documents the Committee has received from seven of the major integrated oil companies will be analyzed in the forthcoming reports.

The final report in the series will make positive recommendations of the Legislative, Executive and Administrative changes necessary to assure the protection of California's vital natural resources.