CALENDAR ITEM
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PRC 91
PRC 163
PRC 425
PRC 426
PRC E-392
J. Planck
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CONSIDER AMENDING THE PRICE BASED SLIDING SCALE ROYALTY FOR STATE OIL AND GAS LEASE NOS. PRC 91, PRC 163, PRC 425, PRC 426, AND PRC E-392, OFFSHORE HUNTINGTON BEACH, ORANGE COUNTY

LESSEE:

SoCal Holding, LLC
Attn.: Mr. Frank J. Komin
111 W. Ocean Blvd., Suite 800
Long Beach, CA 90802

AREA, LAND TYPE, AND LOCATION:

State Oil and Gas Lease Nos. PRC 91 (589 acres), PRC 163 (640 acres), PRC 425 (835 acres), PRC 426 (640 acres), and PRC E-392 (835 acres) (collectively "Leases"), are located in the offshore area of the Huntington Beach Oil Field in Orange County. Platform Emmy is located offshore within PRC 425 and has approximately 28 drilled wells. All of the offshore leases also have wells drilled from onshore Huntington Beach drill sites.

BACKGROUND:

The Leases were originally issued between 1938 and 1950. There have been a number of lease assignments over the years. The current Lessee of record is SoCal Holding, LLC, a subsidiary of California Resources Corporation ("CRC"), the current operator of the Leases.

The Leases were modified over the years from the original sliding scale royalty based on the rates of production of the wells to flat royalties to allow for secondary recovery (i.e., waterflooding). On May 3, 1995, the California State Lands Commission (Commission) approved (Calendar Item 58), a royalty modification for Shell Onshore Ventures, LLC, the lessee at the time, to prevent premature abandonment of the field, to promote the maximum economic recovery from the leased lands, and to preserve an important economic asset for the local community pursuant to Public Resources Code, § 6827.2. The conversion to the new royalty was tied to a number of conditions including implementation of a waterflood program, reduction of operating costs, and further investments in the field. A study completed at that time by a California State University Northridge professor ("Statistical Analysis of the Direct and Indirect Economic Impacts of the Shell Huntington Beach Field on the Los Angeles and Orange County Economy," Anderson) concluded that the operation provided 407 local jobs and significant income to both the local and State economy.

In development of the "oil price based sliding scale" royalty, the Commission relied on two distinct independent analyses. The first was prepared by Dr. Robert T. Deacon, Professor of Economics at the University of California, Santa Barbara, and the second was prepared by Mr. Peter Ashton of Innovation & Information Consultants, Inc., of Cambridge, Massachusetts. Although each report used somewhat differing analytical methodologies, both concluded that the proposed royalty modification would be advantageous for the State. Dr. Deacon analyzed the distribution of prices for the prior 10-year period to develop the sliding scale "oil price based" royalty in use today. The report concluded that the proposed royalty modification would provide an average royalty rate of 16.4%. However, shortly after the new royalty scale was introduced oil prices rose significantly and the royalty rate increased to the highest level of 25% and remained there until the recent collapse of oil prices. The scale has not been modified since 1995 except for automatic monthly adjustments to account for inflation using the U.S. Department of Commerce, Bureau of Labor Statistics' published Producer Price Index for Total Finished Goods ("PPI"). These adjustments have averaged approximately 2.2% per year since 1995.

CRC PROPOSAL:

CRC, by letter dated March 8, 2016, requested that staff review and amend the royalty rate. CRC presented evidence showing it to be in a negative cash flow situation due to the precipitous drop in oil prices and, that the PPI adjustment had not adequately tracked oil field inflation. Before requesting the amendment, CRC reduced its operating costs, statewide and in Huntington Beach, by incurring staff and contractor reductions of more than 50% of its workforce. CRC's proposal, within the framework of the 1995 amendment, requested that the Finished Good's PPI be adjusted upwards by 100 basis points to more accurately reflect oilfield inflation indices, thus generating a new inflation adjusted price based royalty scale.

STAFF ANALYSIS AND RECOMMENDATION:

Pursuant to California Public Resources Code section 6827.2, in order to revise the royalty provisions of the Leases, the Commission must find that continued production from the Leases is in the best interests of the people of California and that such production is economically unfeasible under the current terms set forth in the lease. Pursuant to California Public Resources Code section 6830.1, it has been determined by the Legislature that the people of the State of California have a direct and primary interest in assuring the production of the optimum quantities of oil and gas from lands owned by the State, and to minimize waste and unrecovered oil and gas resources on such lands. Also, as stated above, the Lease, provide significant economic benefit to both the local and State economy.

The Development of Staff's Proposal

Staff evaluated CRC's request by reviewing the information that CRC provided, the current pricing in the oil fields in and around Huntington Beach, as well as the oil price over the last year, and determined that a temporary adjustment to the oil price based sliding scale is both in the best interest of the people of California and necessary for the continued economic feasibility of the Leases. The price-based sliding scale currently in effect was based on a stable long term oil price. Unforeseen and extraordinary fluctuations in the price of oil over the last decade have caused the inflationary relationships for this commodity to deviate disproportionately from the forecasted norm. Staff made a statistical analysis of the various oilfield indices and analyzed the incremental changes to the various indexes over a specified period to find an adjustment more reflective of current conditions. Staff analyzed the steady increase in the PPI index used in the current royalty scale compared to other indices used in oilfields, as well as other similar industries PPI to determine a viable adjustment to the current index to reflect current conditions. The current sliding scale uses the Bureau of Labor Statistics (BLS) Finished Goods inflation PPI. This inflation index has not kept pace with actual inflation in the oilfield which has resulted from the high oil price market. Taking into account the BLS Drilling and BLS Service indexes (used by CRC to justify its 100 point adjustment proposal based on actual oilfield inflation) and extrapolating data from 1996 – 2004 (prior to the historically high commodity prices) confirmed that increasing the BLS Finished Goods Index by 65 basis points (instead of CRC's 100 basis point proposal) would better approximate the observed oil field inflation rate. Further, the 65 point increase approximates the average adjusted inflation seen in other similar industries such as chemical manufacturing and oil and gas field machinery and equipment manufacturing, thus supporting staff's view that increasing the monthly PPI by 65 basis points reflects current overall economic conditions. Staff developed a table (Exhibit B) illustrating the relative variances in state royalty income between the proposals assuming a stable price over two years. Staff's recommended proposal provides royalty relief when prices are at a low level but achieves royalty income parity with the current royalty structure when oil reaches $50 a barrel. Under staff's proposal, a royalty of 16 2/3% is reached when oil reaches $30 a barrel.

State's Best Interest In Continued Production and Development

As illustrated in the economic analysis performed in 1995 and the legislature's policy enshrined in section 6830.1 of the Public Resources Code, both the state and the local communities have a beneficial interest in the continued production of optimum quantities of oil and gas from the leases. In addition, because oil wells have a natural "decline curve" or reduction in oil production over time (10% annually as a rule of thumb), it is necessary for CRC to invest in field development to maintain levels of production under the Leases. A lessee has little incentive to invest in field development to maintain production if the capital expenditures involved exceed the expected return on revenue. Staff believes that adjusting the sliding scale royalty consistent with demonstrated industry price trends will incentivize CRC to continue development of the Leases and maintain production levels consistent with the policy described in Public Resources Code section 6830.1.

Economic Infeasibility Under the Current Leases

From information provided to the Commission, CRC has indicated that it is experiencing a negative cash flow situation due to the precipitous drop in oil prices. Despite a large reduction in its workforce, CRC is in a situation where it appears to be losing money on its current production. Given the historic crash in commodity prices and the continuing need to expend capital investments to maintain consistent production levels, staff believes that the current royalty structure based on a framework developed in 1995 makes production economically unfeasible and justifies an amendment to the royalty provisions.

Staff's Proposal

Based on the analysis above, staff proposes that a revised sliding scale royalty based on a 65 point increase to the monthly BLS Finished Goods inflation index, currently being used to determine the price-based royalty percentage, take effect for two years beginning April 1, 2016, and ending on March 31, 2018. This timeframe will offer CRC immediate relief to ensure that production from the Leases remains economically feasible and allow staff to analyze ongoing oil price trends and to work with CRC on a long-term royalty arrangement that more accurately reflects the market. Any such arrangement should allow the State to recoup any losses should the oil price return to its recent historic levels (e.g. a royalty rate higher than 25%), and/or consider other public benefit or environmental enhancement considerations, which could include contributions to the continued operation and maintenance of the Bolsa Chica Lowlands Restoration Project or other equally favorable public benefits. After two years, if no agreement on a long-term royalty structure is reached, the royalty structure will revert to its current framework based on the 1995 amendment. A comparison of the royalty proposals, the State's potential change in revenue caused by the proposed change to the royalty scale, and the terms of the proposed amendment are included as Exhibits A, B, and C, respectively, to this calendar item.

Commission staff recommends that the royalty provision of the Leases be amended as provided in Exhibit C, attached hereto. The Lessee has agreed to the proposed Lease royalty modification.

STATUTORY AND OTHER REFERENCES:

A. California Public Resources Code section 6827.2
B. California Public Resources Code section 6830.1

OTHER PERTINENT INFORMATION:

1. The staff recommends that the Commission find that the proposed amendment to the subject Leases 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. This action is consistent with California State Lands Commission's 2016-2020 Strategic Plan, Strategy 2.1 to optimize returns for the responsible development and use of State lands and resources, both onshore and offshore; and Strategy 2.2 to ensure timely receipt of revenues and royalties from the use and development of State lands and minerals.

EXHIBITS:

A. Royalty Schedule Comparison
B. Royalty Revenue Comparison
C. Proposed Lease Amendment

RECOMMENDED ACTION:
It is recommended that the Commission:

CEQA FINDINGS:

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

AUTHORIZATION:

1. Find that continued production from State Oil and Gas Lease Nos. PRC 91, PRC 163, PRC 425, PRC 426, and PRC E-392 is in the best interests of the State.

2. Find that such production is currently economically unfeasible under the terms set forth in the Leases and the previous amendments due to the persistent and severely low oil prices.

3. Approve the amendment to the royalty provisions of State Oil and Gas Lease Nos. PRC 91, PRC 163, PRC 425, PRC 426, and PRC E-392, in substantially the same form of that attached as Exhibit C, between the Commission and SoCal Holding, LLC.

4. Authorize the Executive Officer or her designee, to execute, on the Commission’s behalf, an amendment in substantially the form of that attached as Exhibit C.

5. Authorize staff to work with the Lessee on a long-term royalty structure that benefits both parties that recognizes and mitigates severely low commodity prices, but also escalates to appropriate royalties during times of high oil prices. Any long term royalty structure should also include other public benefits and/or environmental enhancement considerations.

Exhibit A

PRC 91, PRC 163, PRC 425,
PRC 426, PRC E-392

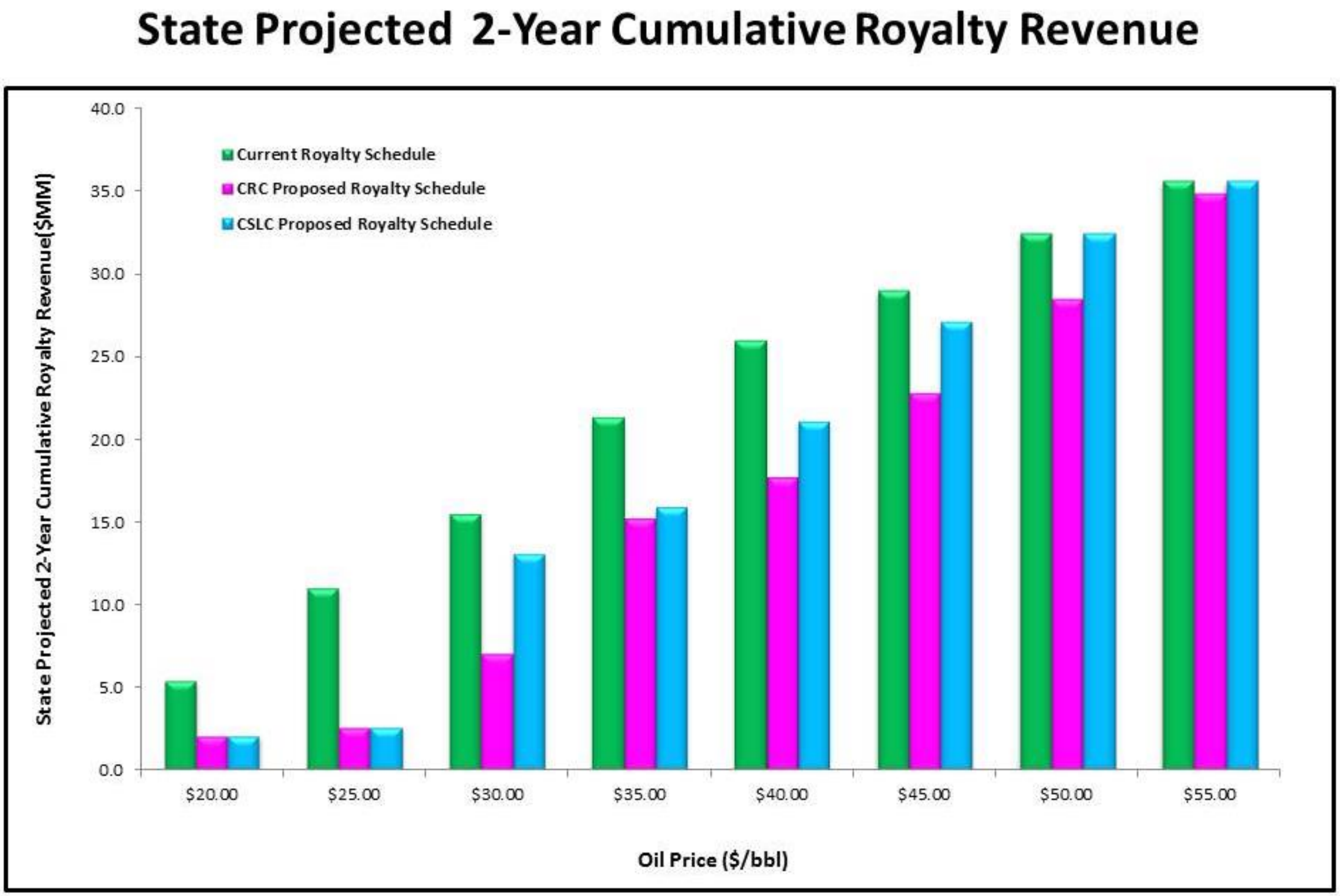
Royalty Schedule Comparison

Current Scale			CRC's Proposed Change			Proposed Change Under Consideration	
Realized Oil Price	Royalty Rate		Realized Oil Price	Royalty Rate		Realized Oil Price	Royalty Rate
$15.00	4.0%		$15.00	4.0%		$15.00	4.0%
$20.00	12.1%		$20.00	4.0%		$20.00	4.0%
$25.00	16.7%		$25.00	4.0%		$25.00	4.0%
$26.00	16.9%		$26.00	4.0%		$26.00	6.7%
$30.00	19.7%		$30.00	9.1%		$30.00	16.7%
$35.00	23.4%		$35.00	16.7%		$35.00	17.0%
$40.00	25.0%		$40.00	17.0%		$40.00	19.8%
$45.00	25.0%		$45.00	19.5%		$45.00	22.6%
$50.00	25.0%		$50.00	22.0%		$50.00	25.0%
$55.00	25.0%		$55.00	24.5%		$55.00	25.0%
$56.00	25.0%		$56.00	25.0%		$56.00	25.0%

Exhibit B

PRC 91, PRC 163, PRC 425,
PRC 426, PRC E-392

Royalty Revenue Comparison



AMENDMENT TO STATE OIL AND GAS LEASES
PRC 91, PRC 163, E 392, PRC 425, AND PRC 426

WHEREAS the State of California by and through the State Lands Commission did lease certain lands known as PRC 91 in Orange County to H. R. Hamilton, Operator, on May 21, 1943, and through successive assignment to SoCal Holding, LLC, on June 14, 2014; and

WHEREAS the State of California by and through the State Lands Commission did lease certain lands known as PRC 163 in Orange County to Signal Oil and Gas Company, on November 15, 1944, and through successive assignments to SoCal Holding, LLC, on June 14, 2014; and

WHEREAS the State of California by and through the State Lands Commission did lease certain lands known as E 392 in Orange County to Southwest Exploration Company on September 26, 1938, and through successive assignments to SoCal Holding, LLC, on June 14, 2014; and

WHEREAS the State of California by and through the State Lands Commission did lease certain lands known as PRC 425 in Orange County to Southwest Exploration Company on February 10, 1950, and through successive assignments to SoCal Holding, LLC, on June 14, 2014; and

WHEREAS the State of California by and through the State Lands Commission did lease certain lands known as PRC 426 in Orange County to Signal Oil and Gas Company, on February 10, 1950, and through successive assignments to SoCal Holding, LLC, on June 14, 2014; and

WHEREAS the State of California, by and through the State Lands Commission and Shell Onshore Ventures, Inc., entered into an agreement to modify the royalty terms of State Oil and Gas leases PRC 91, PRC 163, E 392, PRC 425, and PRC 426, on June 1, 1995 to maintain economic viability and prevent premature abandonment of the leases and to allow for the recovery of additional recovery of oil and gas through the “Upper Main Zone Waterflood Program”; and

WHEREAS, the June 1, 1995 agreement implemented a sliding scale royalty adjusted monthly based on changes in the Producer Price Index, Total Finished Goods as then published by the U.S. Department of Commerce, Bureau of Economic Analysis; and

WHEREAS recently, the price of oil has precipitously declined, from a high of $115 a barrel in June, 2014 to a low of $27 in January 2015, Brent Crude benchmark; and

WHEREAS California Resources Corporation, the operator for of State Oil and Gas leases PRC 91, PRC 163, E 392, PRC 425, and PRC 426, has requested the State Lands Commission to modify the royalty terms in order to maintain the economic viability and prevent premature abandonment on the leases; and

WHEREAS the State Lands Commission and California Resources Corporation have negotiated a modification of the royalty terms based on the June 1, 1995 agreement whereby, in part, additional basis points will be added to the monthly Producer Price Index, Total Finished Goods as published by the U.S. Department of Labor, Bureau of Labor Statistics, for a limited period of two years; and

WHEREAS the State Lands Commission determined on April 5, 2016, that the continued production from said leases is in the best interests of the State and that such production is economically unfeasible under the existing lease terms; and

NOW, THEREFORE, the State and SoCal Holding, LLC do hereby agree as follows:

1. Effective the 1st day of April 2016, the first full paragraph of the second page of Exhibit "A" LEASE ROYALTY MODIFICATION, to the agreement titled "Amendment to State Oil and Gas leases PRC 91, PRC 163, E 392, PRC 425, and PRC 426," executed June 1, 1995, between the State Lands Commission and Shell Onshore Ventures Inc., is hereby struck in its entirety and replaced with the following:

   The price of oil, for application of the sliding scale schedule, during any month when the State is taking its royalty oil in kind, shall be the highest weighted average price received in the sale of oil from the leases during the month by either the Lessee or the State (its entire royalty share, no more or less), deflated by the Producers Price Index ("PPI") to the effective reported PPI for the month of January, 1996 (reported PPI of 129.4). The State will provide evidence in the form of sales contracts to the Lessee no more than fourteen (14) days after execution of the sales contract. If the State is not taking its royalty oil in kind, the price of oil shall be the higher of (1) the highest weighted average price posted for oil of like gravity and quality in the Huntington Beach Field ("Field") among the postings of any reputable company posting prices in the Field that meets the requirements of the State to purchase oil provided that company is capable of purchasing all of the production from the State leases in the Field at its posted prices, or (2) the weighted average price received in the sale of oil during the month by the Lessee. The Lessee shall provide to the State evidence in the form of sales contracts establishing the price of oil not more than fourteen (14) days after the sales contract has been executed.

   Under all methods of valuation, the price of oil shall be deflated by the PPI, Total Finished Goods, as published by the U.S. Department of Labor, Bureau of Labor Statistics, to the month of January, 1996 (reported PPI of 129.4). This conversion will be made using the PPI for the month ending production. This index will be used without regard to any subsequent revisions to the index or the parameters that define the index or changes to the base year included therein. The royalty rate determined from the deflated highest sales price shall be applied to the month ending production, and in the event of in-kind deliveries any overage or underage accounted for in the following month.

   Commencing April 1, 2016 through March 31, 2018, and for each production month therein, 65 points ("PPI Adjustment") shall be added to the PPI "unadjusted index" for purposes of deflating the value of oil for application of the sliding scale schedule. By way of illustration, the deflated price of oil shall be calculated as: [Jan. 1996 PPI of 129.4/(Production Month PPI+65) * (monthly weighted average price of oil)]. This deflated price will then be applied to the sliding scale schedule. Commencing April 1, 2018 and each production month thereafter, no PPI Adjustment will be added for purposes of deflating the price of oil; for purposes of applying the sliding scale schedule the production month PPI shall be the actual "unadjusted index" reported by the Bureau of Labor Statistics.

2. All other terms and conditions of State Oil and Gas leases PRC 91, PRC 163, E 392, PRC 425, and PRC 426 are unchanged and remain in full force and effect.

IN WITNESS THEREOF, the parties hereto have executed this Amendment of State Oil and Gas Leases PRC 91, PRC 163, E 392, PRC 425, and PRC 426.

LESSEE:

SoCal Holding, LLC,
27200 Tourney Road, Ste. 315
Santa Clarita, CA 91355

By:_____________________

Date:___________________

Frank Komin
Executive Vice President, Operations
California Resources Corporation

Acknowledgment

LESSOR:

State of California
State Lands Commission
200 Oceangate, 12th Floor
Long Beach, CA 90802-4333

By:_____________________

Date:___________________

Marina Voskanian
Chief, Mineral Resources Division
State Lands Commission

Acknowledgment