

MINUTE ITEM

This Calendar Item No. C62 was approved as Minute Item No. 62 by the California State Lands Commission by a vote of 3 to 0 at its 4-17-06 meeting.

CALENDAR ITEM
C62

A 67

04/17/06
PRC 3033.1
PRC 3095.1
PRC 3413.1
W 40820

S 35

F. Velez
D. Mercier

**CONSIDER APPROVAL OF SETTLEMENT OF AUDIT
DISPUTE REGARDING ALLOWABLE TRANSPORTATION
AND DEHYDRATION DEDUCTIONS FROM STATE'S ROYALTY,
OIL AND GAS LEASE NOS. PRC 3033.1, PRC 3095.1, AND PRC 3413.1,
HUNTINGTON BEACH AND BELMONT OFFSHORE OIL FIELDS,
ORANGE COUNTY**

APPLICANT:

California State Lands Commission
100 Howe Avenue, Suite 100 South
Sacramento, CA 95825-8202

BACKGROUND:

Oil and Gas Lease Nos. PRC 3033.1, PRC 3095.1 and PRC 3413.1 were issued in 1963, 1964 and 1965, respectively, pursuant to the Cunningham-Shell Tidelands Leasing Act. At that time, the Cunningham-Shell Act prescribed that the leases shall contain a provision allowing the lessees to deduct from the State's royalty their costs of treating and dehydrating the oil. The costs of transporting the oil from the platforms to the onshore sales location were allowed by the terms of the leases as a deduction from State royalties. In 1976, an amendment to the Cunningham-Shell Act was passed that, except in the case of net profits leases, eliminated the allowance for oil treatment, dehydration and transportation in leases issued after January 1, 1977. Because Lease Nos. PRC 3033.1, PRC 3095.1, and PRC 3413.1 were issued in 1963, 1964 and 1965, respectively, the lessees are allowed to make these deductions from the oil royalty payments they make to the State.

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In 1975, the California State Lands Commission (Commission) adopted its Uniform Policy on Allowable Oil and Gas Transportation and Dehydration Deductions (Uniform Policy). The Uniform Policy was adopted to provide an accounting procedure applicable to all oil and gas lessees for determining the types of costs allowable and a uniform method of calculating depreciation on the equipment used for transportation and dehydration of the oil.

When the Uniform Policy came into effect, Union Oil Company of California (later Unocal) was the lessee of Lease Nos. PRC 3033.1 and PRC 3413.1, and Standard Oil Company of California (later Chevron USA, Inc.) was the lessee of Lease No. PRC 3095.1. When paying the State's royalties, both Unocal and Chevron made deductions for oil transportation and dehydration pursuant to the Uniform Policy.

In 1988, Chevron assigned, with Commission approval, Lease No. PRC 3095.1 to Unocal. Unocal, in 1996, assigned with Commission approval, all three leases, PRC 3033.1, PRC 3095.1, and PRC 3413.1, to Nuevo Energy Company (Nuevo). Plains Exploration & Production Company (PXP) acquired Nuevo in a stock transaction in 2004, and subsequently merged Nuevo into PXP. As the result of the merger, PXP acquired ownership of all three leases.

Shortly after Nuevo succeeded to Unocal's and Chevron's interests in the three leases, it stopped deducting oil transportation and dehydration costs from the royalties it paid to the State. This action was not a waiver of its right to take these deductions but a rejection of the State's Uniform Policy precipitating claims for large refunds for the deductions not taken. In October 1998, Shiv Om Consultants, Inc. (Shiv Om) filed on behalf of Nuevo a claim with the Commission staff for a refund of allegedly excess royalties paid under the three leases from October 1995 to August 1998. The amount was \$2.1 million and represented depreciation of oil and gas transportation and oil dehydration equipment and oil and gas post production costs that were inconsistent with the Uniform Policy. Shiv Om submitted a revised claim for the period from October 1995 to October 1999 in the amount of \$3 million and later increased that claim to \$3.2 million.

Commission staff began auditing Nuevo's claim to determine the propriety of the claimed deductions and the extent of their inconsistency with the Uniform Policy. Staff calculated appropriate oil transportation and dehydration deductions consistent with the Uniform Policy for the period October 1995 to October 1999 as \$953,736.

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In June 2005, Shiv Om, now working for PXP upon its acquisition of Nuevo, submitted another claim for excess royalties for the period November 1999 to July 2004. This claim, like the previous one, represented depreciation of oil and gas transportation and oil dehydration equipment and oil and gas postproduction costs that were inconsistent with the Uniform Policy. The claimed amount was \$2.7 million.

Staff undertook the auditing of this claim to determine the propriety of the costs included and compliance with the Uniform Policy. Staff's calculation of the appropriate deductions for oil transportation and dehydration consistent with the Uniform Policy for the period November 1999 to July 2004 was \$1,225,364. In December 2005, staff proposed to PXP a settlement of past claims for excess royalty payments. The proposal was a refund to PXP of \$2,161,100, which consists of the staff's determination of the proper amount of deductible oil transportation and dehydration costs consistent with the Uniform Policy for the two audit periods (\$935,736 and \$1,225,364). This is \$3.8 million less than the consultant's claims. PXP has agreed to this settlement, by letter to Commission dated February 10, 2006, provided that the Commission settles the period from August 2004 through November 2004, covering the period subsequent to the audit period up to the time when Dos Quadras Offshore Resources, LLC (DCOR) assumed operation of the leases. The settlement amount for this period, calculated by the staff, is \$87,000. The total refund to PXP, therefore, will be \$2,248,600. This will be a final settlement of all matters concerning deductions from the State's oil and gas royalties from Lease Nos. PRC 3033.1, PRC 3095.1, and PRC 3413.1 through November 2004. PXP, unlike Nuevo before it, has not pursued and will not pursue any claims for costs for transporting or processing the sweet gas produced from these leases.

PERMIT STREAMLINING ACT DEADLINE:

N/A (not a "development project" subject to the Act)

RECOMMENDED ACTION:

IT IS RECOMMENDED THAT THE COMMISSION:

CEQA FINDINGS:

FIND THAT THE ACTIVITY IS NOT SUBJECT TO THE REQUIREMENTS OF THE CEQA PURSUANT TO TITLE 14, CALIFORNIA CODE OF REGULATIONS, SECTION 15060(c)(3)

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BECAUSE THE ACTIVITY IS NOT A PROJECT AS DEFINED BY PUBLIC RESOURCES CODE SECTION 21065 AND TITLE 14, CALIFORNIA CODE OF REGULATIONS, SECTION 15378.

AUTHORIZATION:

APPROVE A REFUND TO PLAINS EXPLORATIONS AND PRODUCTION COMPANY IN THE AMOUNT OF \$2,248,600 (\$2,161,100 + \$87,500) FOR OIL DEHYDRATION AND TRANSPORTATION COSTS NOT DEDUCTED, IN SETTLEMENT OF OUTSTANDING AUDITS COVERING THE PERIODS OCTOBER 1995 THROUGH OCTOBER 1999, AND NOVEMBER 1999 THROUGH JULY, 2004, AND THE SUBSEQUENT PERIOD OF AUGUST 2004 THROUGH NOVEMBER 2004.