

MINUTE ITEM

12/19/74
ADW

27. REQUEST FOR APPROVAL TO MODIFY THE STATE OIL ROYALTY RATES ON TRACTS PARTICIPATING IN THE 91.1 MAIN ZONE UNIT, HUNTINGTON BEACH FIELD, ORANGE COUNTY - W 9721.

During consideration of Calendar Item 25 attached, Mr. E. N. Gladish, Executive Officer, informed the Commission that the item was a request to 1) protect the State's royalty interest in the 91.1 Main Zone Unit, and 2) protect the State's energy supply from a broad standpoint by modifying certain lease royalty rates, referring specifically to a number of leases combined into what is known as the 91.1 Main Zone Unit. He explained the history of the Unit and the individual lease oil-price-sensitive royalty rates. Mr. Gladish explained that at the time the Unit was formed in 1962 the crude oil prices were such that the average royalty rate was about 22 percent. At today's prices, however, the applicable royalty rate is about 84 percent. Because of the nonprofitability of the Unit, Mr. Gladish indicated that Burmah and other members in the Unit had come to the State and advised that unless an adjustment in the royalty rate was forthcoming, they would be compelled to dissolve the Unit. He explained that if Burmah could terminate the Unit, the State would sustain a significant revenue loss.

Mr. Gladish concluded by stating that the recommended action will modify the royalty rates, place the Unit on a profitable basis, and protect the State from possible loss of revenue in terms of breaking the Unit, and will have little effect on long-term revenue. Mr. Gladish submitted for the record a letter from Mr. A. C. Marion, Mar Rico Oil Company, to the State Lands Commission, dated December 16, 1974, said letter being on file in the office of the State Lands Commission and by reference made a part hereof. After questions were clarified which were raised in the discussion that followed Mr. Gladish's presentation, the item was approved as indicated.

Upon motion duly made and carried, the following resolution was adopted:

THE COMMISSION AUTHORIZES THE APPROVAL OF THE TERMS OF AGREEMENTS AND DELEGATION OF AUTHORITY TO THE STAFF TO ENTER INTO AGREEMENTS WITH THE VARIOUS LESSEES OF THE LEASES INCLUDED WITHIN THE 91.1 MAIN ZONE UNIT AMENDING AND MODIFYING SAID LEASES FOR THE PURPOSES OF CONTINUING A PROFITABLE LIFETIME OF THE 91.1 MAIN ZONE UNIT AGREEMENT AND MAXIMIZING THE STATE'S INCOME THEREUNDER, MORE PARTICULARLY DESCRIBED IN EXHIBIT "A" ATTACHED AND BY REFERENCE MADE A PART HEREOF.

Attachment:

Calendar Item 25 (6 pages)

Minute item <u>27</u> , meeting of <u>12/19/74</u>	RESCINDED
by minute item <u>24</u> , meeting of <u>4/30/75</u>	<u>AD</u>
<u>page 450</u>	(Initials)

REQUEST FOR APPROVAL TO MODIFY THE STATE OIL ROYALTY RATES ON TRACTS
PARTICIPATING IN THE 91.1 MAIN ZONE UNIT, HUNTINGTON BEACH FIELD,
ORANGE COUNTY

On March 30, 1972 (Minute Item 8, page 171), the Commission authorized the approval of the 91.1 Main Zone Unit for conducting secondary oil recovery (Waterflood) operations in the Main Zone on the 91.1 Lease area. The Unit became effective on April 1, 1972.

The Unit comprises 49 participating State "Easement Well" leases and the PRC 91.1 Lease. The Unit Agreement provides for a primary and secondary period of oil production. The secondary production period is further divided into a "recoupment period" and an "after recoupment period". Each easement well lease or tract that had economic oil production at the beginning of the unit operation is allocated a share of oil production during the primary production period in accordance with its primary oil reserves. During this period each tract is obligated to pay its own royalties, taxes, and a primary tract operating expense but does not pay any other unit expense. All unit expense including capital investment and operating expenses with respect to initiating and carrying out secondary recovery operations during the primary and secondary production periods are borne by the Unit Operator (Burmah Oil and Gas Company). These costs are recovered by Burmah during the recoupment period through the allocation of all oil production during this portion of the secondary period to its PRC 91.1 Lease.

The State receives royalty from each tract during the primary and secondary production periods in accordance with the provisions set forth in the amendment to its lease for secondary recovery operations. At the beginning of unit operations, 29 of the 49 unit tracts and the 91.1 Lease were assigned primary oil production participation from which State royalties are determined and paid. During the total secondary oil production period each of the 49 tracts are allocated 1/2 of 1% of the total unit oil production for State royalty purposes (aggregate total of 24.5%) and the 91.1 lease is allocated the balance of 75.5%.

Of the 29 tracts receiving primary oil production, 25 pay State royalty based upon a price sensitive royalty formula which approximates 8 times the price of a barrel of oil. If the applicable oil price is \$3 per barrel, the royalty rate is 24%; if 9\$ per barrel, the royalty rate is 72%, etc. The 4 remaining tracts and the 91.1 lease pay a State royalty rate of 12.5%. Burmah owns the controlling interest in 14 tracts which pay State royalty on the price sensitive formula, and 2 tracts and the 91.1 lease which pay 12-1/2% royalty. The 20 tracts that do not participate in the primary oil production, pay no State royalty during this period; however, during the secondary production period they pay a State royalty rate of 16-2/3% or 12-1/2% in accordance with lease terms.

CALENDAR ITEM NO. 25 (CONTD)

Prior to unitizing the Lower Main Zone for waterflooding, the recoverable oil reserves in the 91.1 lease area were estimated by Burmah (then Signal Oil and Gas Company) to be 12,500,000 barrels. The price of crude oil was about \$2.60 per barrel. An in-house economic study prepared by Burmah on the proposed project was reviewed by the State and showed a rate-of-return of about 17% without any provision for risk.

Following approval of the Unit, Burmah commenced drilling operations from a new upland drilling tract, abandoned townlot easement wells and constructed production and water injection facilities. In the ensuing period to January 1974, Burmah expended some \$4,000,000 of the initial projected \$7,000,000 of capital investment on the project. During the same period it became evident from reservoir information acquired through new well drilling and waterflood performance, that the ultimate recoverable oil would be about 4,000,000 barrels rather than 12,500,000 barrels as was initially projected. With this reduction in recoverable oil and under the crude oil prices in effect at the beginning of waterflood operations, the economics of the Unit were threatened and became uneconomical with respect to recovery of past capital investment.

Effective September 1, 1973, the Cost of Living Council established the two-tier crude oil pricing system. Under its rules the 91.1 Main Zone Unit qualified to receive the new oil price for its oil production. By December 1973, the new oil price had risen to \$9.38 per barrel, and in December 1974, the price was increased to \$10.43 per barrel retroactive to October 1, 1974. This sudden increase in oil price would seem to give the Unit new economic life. However, at the same time it caused the State primary oil royalty rate to skyrocket to over 75% in December 1973, and to over 84% with the most recent price increase, on those easement well tracts whose royalty rates are calculated by the price sensitive formula. Inasmuch as about 77% of primary oil production is allocated to these tracts and the majority of revenue received by Burmah to offset Unit operating expense is from those 14 tracts controlled by Burmah, the economics of the Unit were again in jeopardy.

In March 1974, Burmah formally petitioned the State for royalty relief on primary oil production allocated to the easement well tracts. Without royalty relief, Burmah said it would be compelled to terminate the Unit. If the Unit were terminated, in accordance with the Unit Agreement the Unit producing zone, wells and facilities would revert to the 91.1 lease which carries a State royalty rate of only 12-1/2%. In ensuing negotiations with Burmah and others, the question of whether or not the Unit could be legally terminated was discussed at length without any agreement between parties. It was clear to the State that successful termination of the Unit would result in a considerable loss in oil royalties (\$7,000,000) and with continued operation under unreasonably high-primary oil royalty rates, wells would be prematurely shut-in resulting in lower oil recovery, and consequently lower oil royalties.

CALENDAR ITEM NO. 25. (CONTD)

In the initial meetings with Burmah, the State agreed to work to resolve the problem and suggested that a joint economic study be made to determine a reasonable tract primary oil royalty rate that would enable the Unit to continue to operate economically. The State retained the services of Petroleum Engineering Consultant, Nick Van Vingen, to sit in on the meetings as an expert observer. After many case studies and negotiations, it was agreed that the future primary oil royalty rate on the easement well tracts controlled by Burmah would be reduced to 45%, but that a 75% royalty rate would apply for determination of tract royalty rate during the secondary oil production period. For this reduction in royalty rates, Burmah has agreed to increase their 91.1 Lease Main Zone royalty rate during the secondary period to 19%, to enable the State to recover the royalties given up during the remainder of the primary production period.

IT IS RECOMMENDED THAT THE COMMISSION AUTHORIZE THE APPROVAL OF THE TERMS OF AGREEMENTS AND DELEGATION OF AUTHORITY TO THE STAFF TO ENTER INTO AGREEMENTS WITH THE VARIOUS LESSEES OF THE LEASES INCLUDED WITHIN THE 91.1 MAIN ZONE UNIT AMENDING AND MODIFYING SAID LEASES FOR THE PURPOSES OF CONTINUING A PROFITABLE LIFETIME OF THE 91.1 MAIN ZONE UNIT AGREEMENT AND MAXIMIZING THE STATE'S INCOME THEREUNDER, MORE PARTICULARLY DESCRIBED IN EXHIBIT "A" ATTACHED AND BY REFERENCE MADE A PART HEREOF.

Attachment: Exhibit "A"

Exhibit A

RESOLUTION OF APPROVAL OF THE TERMS OF AGREEMENTS AND DELEGATION OF AUTHORITY TO THE STAFF TO ENTER INTO AGREEMENTS WITH THE VARIOUS LESSEES OF THE LEASES INCLUDED WITHIN THE 91.1 MAIN ZONE UNIT AMENDING AND MODIFYING SAID LEASES FOR THE PURPOSES OF CONTINUING THE PROFITABLE LIFETIME OF THE 91.1 MAIN ZONE UNIT AGREEMENT AND MAXIMIZING THE STATE'S INCOME THEREUNDER.

I

The Commission hereby approves the terms of, and delegates to the staff authority to enter into, an agreement with Burmah Oil and Gas Company and its co-lessees amending and modifying PRC 91.1 and all other leases in which a partial or complete interest is held by Burmah Oil and Gas Company and presently included within the 91.1 Main Zone Unit as follows:

(1) Each of the leases included in the 91.1 Main Zone Unit Agreement in which a partial or complete interest is held by Burmah Oil and Gas Company, other than PRC 91.1, will be amended to impose a maximum State oil royalty rate of 45% on oil allocated under the Unit Agreement to such leases after December 1, 1974 for the lifetime of the primary oil production period. For purposes of the secondary oil production period, on these same leases, the current price-sensitive royalty formula (that formula applicable to secondary production before the execution of any agreement pursuant to this resolution) will be unchanged except that a 75% maximum oil royalty rate will be effective from October 1, 1974.

(2) PRC 91.1 will be amended so that the royalty due to the State from Burmah Oil and Gas Company and its co-lessees excluding Exxon Company, U.S.A., as to the Main Zone (the unitized formation), will be increased to the rate of 19% of 76 2/3% of the oil production allocated to PRC 91.1 under the Unit Agreement during the secondary production period; provided, however, that in the event of the termination of the 91.1 Main Zone Unit Agreement, the PRC 91.1 Main Zone royalty rate on secondary production shall remain 19% of 76 2/3% of PRC 91.1's Main Zone oil production throughout the lifetime of PRC 91.1's Main Zone.

(3) PRC 91.1, as to the Main Zone, and each of the other leases in which a partial or complete interest is held by Burmah Oil and Gas Company and which is presently included within the 91.1 Main Zone Unit Agreement will be amended to provide that in the event the 91.1 Main Zone Unit Agreement is terminated by the voluntary action of all or any of the working interest owners, which action includes but is not limited to the exercise of rights granted pursuant to paragraph 18.2 of the Unit Agreement, Burmah Oil and Gas Company will pay to the State the dollar difference between the royalties actually received by the State and the royalties the State would have received if the royalty rates of the subject leases had not been modified in accordance with an agreement entered into pursuant to this resolution; provided, 1210

however, that the provisions of this paragraph shall not apply to termination of the Unit Agreement pursuant to paragraph 18.1 of the 91.1 Main Zone Unit Agreement.

(4) Each lease in which a partial or complete interest is held by Burmah Oil and Gas Company and which is presently included in the 91.1 Main Zone Unit Agreement will be amended to provide that said lease may not be quitclaimed or otherwise surrendered to the State or any other party without the prior written consent of the State which shall not be unreasonably withheld.

II

The Commission hereby approves, and delegates to the staff authority to enter into, separate agreements with all of the lessees of all of the leases presently included in the 91.1 Main Zone Unit Agreement other than those leases in which a partial or complete interest is held by Burmah Oil and Gas Company, amending and modifying their respective leases included within the 91.1 Main Zone Unit as follows:

(1) Each of the subject leases will be amended to impose a maximum State oil royalty rate of 75% of the oil allocated to each such lease under the Unit Agreement after December 1, 1974, throughout the primary production period of the 91.1 Main Zone Unit Agreement; provided, however, that in the event of termination of the Unit Agreement during the primary production period, the amendment provided for in this paragraph will cease to be effective and the royalty rate presently provided for in each such lease shall be reinstated. Notwithstanding any provision of this paragraph, the royalty rate formula applicable to the oil allocated to the respective subject leases under the Unit Agreement during the secondary period shall be unchanged by amendments made pursuant to this resolution.

(2) Each of the subject leases will be amended so that in the event that the 91.1 Main Zone Unit Agreement is terminated by the voluntary action of any or all of the Working Interest Owners, which action includes but is not limited to an exercise of rights granted pursuant to paragraph 18.2 of the Unit Agreement, the respective lessees will pay to the State the dollar difference between the royalties actually received by the State and the royalties the State would have received if the royalty rates of the subject leases had not been modified in accordance with an agreement or agreements entered into pursuant to this resolution.

(3) Each of the subject leases will be amended so that said leases may not be quitclaimed or otherwise surrendered to the State or any other party without the prior written consent of the State which shall not be unreasonably withheld.

III

Provided, however, that no agreement pursuant to Part II of this resolution shall be executed unless and until the agreement approved in Part I has been executed; however,

separate agreements pursuant to Part II are independent of each other and may be entered into without regard to the number and timing of such agreements after the agreement authorized by Part I is executed.

Provided further, however, that any agreements entered into pursuant to Parts I or II of this resolution are subject to advice of the Office of the Attorney General that the written agreements (1) adequately accomplish the purposes of this resolution and (2) comply with all applicable law.