MINUTE ITEM

7/24/75
KBY
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3. STAFF RECOMMENDATIONS OF POLICIES RELATIVE TO TRANSPORTATION AND DEHYDRATION DEDUCTIONS ON OFFSHORE STATE OIL AND GAS LEASES - W 9767.

After consideration of Calendar Item 1 attached, and upon motion duly made and carried, the following resolution was adopted:

THE COMMISSION:

1. ADOPTS EXHIBIT "A", ATTACHED AND BY REFERENCE MADE A PART HEREOF, AS COMMISSION POLICY ON TRANSPORTATION AND DEHYDRATION DEDUCTIONS.

2. AUTHORIZES THE EXECUTIVE OFFICER OR HIS DESIGNEE TO REVIEW CURRENT AGREEMENTS OR APPLICATIONS FOR TRANSPORTATION AND/OR DEHYDRATION DEDUCTIONS AND REQUESTS NEW APPLICATIONS IN THE EVENT THE CURRENT APPLICATIONS ARE NOT IN CONFORMANCE WITH EXHIBIT "A".

Attachment:
Calendar Item 1 (8 pages)

CALENDAR ITEM

1.

7/75
KBY
ADW
W 9767

STAFF RECOMMENDATIONS OF POLICIES
RELATIVE TO TRANSPORTATION AND DEHYDRATION
DEDUCTIONS ON OFFSHORE STATE OIL AND GAS LEASES

Staff has conducted a study to develop a uniform policy on allowable transportation and dehydration deductions applicable to State royalty oil produced from all existing offshore oil and gas leases.

TRANSPORTATION DEDUCTIONS

Prior to the amendment of Section 6827 of the Public Resources Code in 1955, the Division was advised by the Office of the Attorney General that transportation costs of State royalty oil should be allowed as a deductible item from State oil royalties on the rationale that there was an absence of a posted price at the well for an offshore drill platform.

Section 6827 of the Public Resources Code defines the royalty payment ". . . as a percentage of the current market price at the well . . ." and thus by implication provides for deductions from the State's royalty for transportation expenses of State royalty oil from offshore production locations to onshore facilities.

Section 2160 of the California Administrative Code, regarding the disposal of royalty oil taken in kind, stipulates that when provided for in the lease, the lessee shall be reimbursed for the ". . . actual cost of delivery of the royalty share of crude oil to onshore storage and transportation facilities . . ." Further, the current offshore State oil and gas lease form states: "The current market price at the well shall be determined by the State . . ., subject to an appropriate allowance for the cost of delivery of such oil to onshore storage and transportation facilities."

DEHYDRATION DEDUCTIONS

Section 6827 of the Public Resources Code, as amended in 1955, provides ". . . Such royalties shall be paid in kind or as a percentage of the current market price at the well . . . subject to an allowance for oil treatment and dehydration of not to exceed five cents ($.05) per barrel for royalty oil . . . ."

Section 2118(a) of Title 2 of the California Administrative Code provides for a dehydration allowance which shall be ". . . the actual cost of dehydration not to exceed 5 cents per barrel of oil so dehydrated, . . ." and the current offshore State oil and gas lease form contains language relating to dehydration stating that ". . . the lessee shall be entitled to an allowance of actual costs not to exceed five cents ($.05) per barrel . . . ."

SUMMARY

As provided for in the statutes and the offshore oil and gas lease forms, the intent to allow transportation and dehydration deductions from royalty oil is quite clear, while the deductible cost elements are not. The latter factor has lead to inconsistency in the administration of these provisions of the lease. Staff determined that clarification was required in two major areas: (a) definition of system elements, and (b) determination of allowable and unallowable costs.

Using the definition of the transportation and dehydration system elements developed by the staff, a study was conducted to determine uniform allowable and unallowable costs. Attached as Exhibit "A" is a summary of the determinations of the study, and a recommended policy of transportation and dehydration deductions from royalties paid under existing offshore oil and gas leases.

The staff study also sets forth a recommendation on prospective offshore oil and gas leases to eliminate the present deductibility of transportation and treatment and dehydration costs in order to remove the State as a participant in any lessee costs.

In order to make the State a royalty interest that does not participate in costs, the Public Resources Code, the California Administrative Code, and the current State offshore oil and gas lease form would have to be amended. This recommendation, of course, would not be applicable to State leases or agreements issued on the basis of participation by the State in net profits.

EXHIBIT: A. Summary and Recommended Policy on Transportation and Dehydration Deductions.

IT IS RECOMMENDED THAT THE COMMISSION:

1. ADOPT EXHIBIT "A", ATTACHED AND BY REFERENCE MADE A PART HEREOF, AS COMMISSION POLICY ON TRANSPORTATION AND DEHYDRATION DEDUCTIONS.

CALENDAR ITEM NO. 1. (CONTD)

2. AUTHORIZE THE EXECUTIVE OFFICER OR HIS DESIGNEE TO REVIEW CURRENT AGREEMENTS OR APPLICATIONS FOR TRANSPORTATION AND/OR DEHYDRATION DEDUCTIONS AND REQUEST NEW APPLICATIONS IN THE EVENT THE CURRENT APPLICATIONS ARE NOT IN CONFORMANCE WITH EXHIBIT "A".

Attachment: Exhibit "A"

EXHIBIT "A"

I. DEFINITION OF TERMS: OIL TRANSPORTATION AND DEHYDRATION SYSTEMS

A. Oil Transportation System

The oil transportation system consists of those facilities required to transport produced oil from the offshore structure to the onshore storage facility. It includes transfer pumps, oil lines only, and necessary related equipment. Specific types of equipment include the following:

Barges

Cathodic protection equipment

Chemical injection pumps

Interconnecting piping, valves, and fittings

Meters to detect leaks

Motor starters and switch gear

Offshore surge tanks

Oil lines only

Pigging facilities

Transfer pumps and prime movers

B. Oil dehydration System

The oil dehydration system consists of those facilities required to clean and dehydrate produced oil and includes site, all related lines, tanks, vessels and other equipment utilized in the treatment and dehydration of produced oil. Specific types of equipment include the following:

Boilers and ancillary equipment

Buildings

Chemical injection pumps and tanks

Circulating pumps

Deaerator tanks

Free water knockouts

Heater treaters

Interconnecting piping, valves, and fittings

Landscaping required by local ordinances

Reject oil network

Surge tanks

Wash tanks

ANY VARIANCES FROM A OR B ABOVE MUST BE APPROVED BY THE STATE LANDS DIVISION.

II. ENUMERATION OF COSTS: OIL TRANSPORTATION AND DEHYDRATION DEDUCTIONS

A. Allowable costs of operating, maintaining, and repairing the Oil Transportation System on Existing Offshore Oil and Gas Leases

Chemicals

Depreciation

Direct Labor: Salary and payroll burden of own labor (including field supervision, if charged direct)

Insurance (for facility damage only)

Interest: 6% interest on undepreciated investments in appropriate equipment on leases existing on September 30, 1975.

Maintenance and Repairs

Materials and Supplies (directly used on, or in, the system)

Overhead Allowance

Property Taxes, unless such costs are specifically denied by the terms of the lease agreement.

Right-of-way Payments (offshore to onshore facilities)

Utilities

B. Allowable costs of operating, maintaining, and repairing the Oil Dehydration System on existing oil and gas leases

Operating expenses include all costs of operating, maintaining, and repairing the above facilities. Allowable costs as listed under the oil transportation system, with the following changes:

Add: Site rental

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Delete: Right-of-way Payments (Rev. 7/22/75)

C. Costs that will not be allowed

Costs of company personnel time for surveillance to, from, or on the off-shore structure in addition to their other duties

Costs of separating gas from oil, including related labor

Costs of transporting gas and water, including related labor

Costs of transporting personnel offshore

Costs of waste water disposal

Self insurance

D. Costs of treatment of produced oil

If a lessee obtains State Lands Commission prior approval, then costs that are incurred in removing any foreign substances from produced oil other than basic sediment and water, e.g., reducing the sulphur content, will be deductible subject to either of the following conditions:

1. The oil is not marketable unless treated; or
2. The price of the oil would be lowered if it were not treated, and the State would benefit by sharing in the treating costs; i.e., the incremental price increase per barrel of oil exceeds the cost of treating.

E. Accounting information

Actual costs: Royalty statements should show actual costs for transportation and dehydration deductions. Actual costs can be of two types:

1. Those directly attributable to the systems; and
2. Those allocated to the systems.

On allocated costs, the allocation basis must be completely explained, for Division approval.

Recognition of costs: Costs will be considered as "actual" when funds are expended. Costs which are chargeable to more than one month may be allocated over the appropriate periods, if the total cost can be verified by audit.

Equipment: The depreciable life of equipment shall be 20 years, with a deduction of 10% for salvage value when computing the depreciable costs thereof. Upon submission of substantiating data, abandonment costs will be allowed up to an amount equaling the salvage value.

Lessee is to submit a schedule detailing equipment, diagrams of such equipment, the original cost, the depreciation that will have been deducted on the royalty statements by September 30, 1975, and the undepreciated cost at that time.

Overhead allowance: If field supervision (first-line only) is not charged as a direct actual labor cost, then we will allow an overhead allowance of 15% (10% for field supervision and 5% for general overhead) of direct labor costs.

If field supervision is charged as a direct actual labor cost, then we will allow only 5% of direct labor costs (excluding such field supervision costs) for general overhead.

ANY DEVIATIONS FROM ANY OF THE ITEMS IN SECTION II MUST BE APPROVED BY THE STATE LANDS DIVISION.

III. EFFECTIVE DATES: APPLICATIONS FOR TRANSPORTATION AND/OR DEHYDRATION DEDUCTIONS

In order to be able to deduct transportation and/or dehydration costs in the future, operators of offshore leases must file a new application for transportation and/or dehydration deductions. The definitions and deductions listed in this Exhibit "A" are to be effective October 1, 1975.

A. Lessees currently producing, but not deducting transportation and/or dehydration costs

1. Allow retroactivity of deductions to the beginning of the month preceding the month in which an application is filed. This retroactivity is also to apply to any application for transportation

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and/or dehydration which has not been acted upon by the Division on the effective date of this Calendar Item, but using the definitions and deductions listed in this Exhibit "A".

B. Lessees currently producing, and currently deducting transportation and/or dehydration costs

1. Allow deductions under the new criteria beginning October 1, 1975, if a new application is filed on or before September 30, 1975.
2. Allow deductions under the new criteria beginning from the first of the month following the month in which a new application is filed, if said application is filed after September 30, 1975; and allow no deductions beginning October 1, 1975 through the month that the new application is filed.

C. Lessees currently not producing

1. Allow retroactivity of deductions to the beginning of the month preceding the month in which an application is filed, or to the date of first production, whichever is the shorter period of time.

IV. POLICY ON PROSPECTIVE OFFSHORE OIL AND GAS LEASES

Staff proposes the elimination of the present deductibility of transportation and treatment and dehydration costs, and the elimination of any lessee costs on offshore oil and gas leases which may be issued in the future, to make the State a royalty interest that does not participate in costs. In order to achieve this objective, staff recommends that the Public Resources Code, the California Administrative Code, and the current offshore oil and gas lease form be amended to specifically eliminate all the above-noted costs as deductible items from the State's royalties. This proposal, of course, would not be applicable to State leases or agreements issued on the basis of participation by the State in net profits.