CALENDAR ITEM
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M. Voskanian
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CONSIDER APPLICATION FOR TWO OFFSHORE NEGOTIATED SUBSURFACE (NO SURFACE USE) OIL AND GAS LEASES, AND DEVELOPMENT OF THE LEASES FROM AN OFFSHORE FEDERAL PLATFORM, SANTA BARBARA COUNTY

APPLICANT:

Plains Exploration & Production Company (PXP)
Attn.: Steven Rusch
5640 South Fairfax Ave.
Los Angeles, CA 90056

AREA, LAND TYPE, AND LOCATION:

One subsurface (no surface use) Oil and Gas Lease would be 4964.34± acres, and the second subsurface (no surface use) Oil and Gas Lease would be 5261.89± acres. Both are in the area offshore of Vandenberg Air Force Base located in northern Santa Barbara County, California.

BACKGROUND:

Since 1938, the State Lands Commission (“SLC” or “Commission”) has had exclusive jurisdiction over the leasing of oil and gas from offshore state lands. Public Resources Code, Division 6 and by the Commission’s own regulations as provided in California Code of Regulations, Title 2, Division 3, Chapter 1 provide the scope of the Commission’s jurisdiction and establish requirements and criteria for protection and promotion of the state resources on these lands.

Between 1938 and 1968, over fifty offshore oil and gas leases were issued by the

Commission. In a manner common to most oil and gas leases, the leases that the Commission issued were either devoid of a fixed end date or were subsequently amended to remove an end date. The lease terms typically provided that the leases lasted as long as oil and gas was being produced in paying or commercial quantities. Once production ceases, the leases are to be quitclaimed back to the Commission. Two August 1968 leases, one to Continental Oil Company and the other Standard Oil Company, were the last new offshore oil and gas leases that the Commission entered into prior to the January 1969 Santa Barbara oil spill. The spill was the result of a well drilling blow-out at Union Oil's then-recently constructed Platform A located in federal Outer Continental Shelf (OCS) Tract 402. The cause was inadequate protective wellpipe casing, constructed below both federal and state standards. According to Santa Barbara County's website, the event lasted eleven days, spilled between 80,000 and 100,000 barrels of crude oil. Two hundred square miles of ocean and thirty-five miles of California coastline were oiled and thousands of animals were killed.

At its February 1969 meeting the Commission deferred the acceptance of outstanding bids for new leases and subsequently deferred deadlines for additional drilling from existing leases. Since then, the Commission has not entered into any new offshore oil and gas leases. The Commission formally imposed a moratorium in 1988 and 1989. Since 2001, the Commission has passed eight resolutions opposing the resumption or expansion of federal offshore oil and gas leasing operations (See Exhibit H for two examples). The foundation for each resolution was the same – that the danger of an oil spill like the 1969 Santa Barbara oil spill was too high and that oil development and potential spills would adversely affect fishing, tourism, and environmental, recreational, economic, scenic and other values. The resolutions are also based on and expressive of the state's policy and practice of not issuing new offshore leases. Further, the Commission staff has been pro-active in obtaining quitclaims of existing offshore oil and gas leases from oil companies back to the State.

The California Legislature has a similarly long history of excluding areas from leasing for offshore oil and gas. Beginning in 1921, and many times since, the Legislature has enacted laws that set aside offshore areas where oil and gas leasing was generally prohibited. The 1921 Leasing Act prohibited the issuance of any prospecting permits or leases within one mile of any municipality. The 1921 Act was amended in 1929 to prohibit the issuance of any new lease in offshore state waters. Between 1938 and 1955, leases could only be issued by

the Commission if drainage of the state's oil and gas could be shown. In 1955, the Legislature authorized new oil and gas leases in state offshore waters, but has steadily increased the area which is closed to these leases. Finally, the California Coastal Sanctuary Act of 1994 ("Sanctuary Act"; Public Resources Code Section 6240, *et seq.*) removed all state lands underlying the Pacific Ocean from the Commission's oil and gas general leasing authority. The Sanctuary Act contains two limited exceptions, one of which is being utilized to consider Plains Exploration and Production Company's (PXP) application and is discussed in greater depth below.

The application presently before the Commission is similar to a 1999 joint application by Nuevo Energy Company and Bellwether Exploration Company. That application was denied by Santa Barbara County prior to the Commission having a chance to consider it. PXP's current proposed project, the Tranquillon Ridge project, is the subject of an agreement between PXP and several environmental groups led by the Environmental Defense Center and has been approved by Santa Barbara County. If the Commission approves PXP's application, PXP still needs to receive approval from the California Coastal Commission (CCC) and the Minerals Management Service of the U.S. Department of Interior (MMS). This too will be described in more detail below.

The Commission's Authority to Consider PXP's Application

In April 2005, PXP submitted an application for negotiated subsurface (no surface use) Oil and Gas Leases totaling approximately 10,225 acres, offshore in northern Santa Barbara County (see Exhibit B) using Platform Irene located in federal OCS waters to drill and develop the leases. In April 2008, PXP reduced the number of wells from the earlier proposed thirty wells contemplated by the project and reviewed in the EIR to seventeen and included an end date for production of oil and gas from the project of December 31, 2022.

PXP is the current lessee of the federal OCS leases 437, 438, 440 and 441 that are contiguous to the proposed state lease areas. These leases are for the development of the federal Point Pedernales field. PXP owns and operates Platform Irene, constructed in 1985 by PXP's predecessor and located on OCS Tract 441. Oil and gas produced from those federal leases is currently transported separately by pipelines to the Lompoc Oil and Gas Processing Facility (LOGP) for processing and sale. PXP owns and operates both the pipelines, crossing state lands under State Lands Commission lease PRC 6923.1 (an amendment of which is also on the agenda for this meeting) and the LOGP.

PXP's application is to develop state oil and gas resources by drilling up to seventeen wells from Platform Irene, of which fourteen are contemplated to be producing wells and three are proposed to be injection wells. PXP has made application to the MMS for a proposed Right of Use and Easement (RUE) to be entered into between MMS and PXP to drill the state wells from Platform Irene. The production would be measured and commingled with the ongoing federal Point Pedernales Field production and then transported through the pipelines to the LOGP.

The California Coastal Sanctuary Act prohibits new oil and gas leases in offshore lands, including the lands which PXP has applied to lease. One of the two exceptions in the Act allows the Commission to issue offshore oil and gas leases for areas in the Sanctuary if the Commission finds that state oil or gas is being drained by means of producing wells on an adjacent federal lease and that the issuance of a lease or leases is in the best interest of the state (Public Resources Code Section 6244). The 1992 version of the Sanctuary Act, subsequently repealed and re-enacted by the current Act, contained a requirement that wells in state waters could only be drilled from existing offshore platforms or from onshore locations. Although this requirement was not carried into the current Act, Public Resources Code Section 6815(b) requires that negotiated leases, which are those that could be issued under the exception to the Sanctuary Act, be developed by drilling from adjacent lands. PXP's application is consistent with those requirements.

Public Resources Code Section 6815(a) authorizes the Commission to negotiate oil and gas leases, rather than utilize an open-bidding process, if certain conditions exist. Due to the inaccessibility from surface drill sites reasonably available or obtainable by any party other than PXP and the drainage of state resources by wells located in federal waters, discussed in more detail below, staff believes that these leases are not subject to the open or competitive bidding process. The lease would permit Commission approved directional drilling from Platform Irene and production processing by the current onshore infrastructure.

The federal Point Pedernales project was initially developed and operated by Union Oil Company, but is currently being developed and operated by PXP. It utilizes Platform Irene, which has a total of 72 well slots on the platform. Platform Irene sits in 242 feet of water on federal OCS lands and was set in place in 1985. Twenty-eight wells have been drilled, with a maximum of 15 wells producing in any given month. Thirteen are currently in production. While the original Tranquillon Ridge project proposed by PXP envisioned thirty wells producing

over a thirty year period, after PXP reached an agreement with several Santa Barbara non-governmental organizations the project life was reduced and included a specific end date. The agreement and the parties are discussed below. The project, as now contemplated by PXP, calls for drilling up to 17 wells from Platform Irene (approximately four and a half miles offshore) into two new state leases, with all state drilling and production to cease on or before December 31, 2022. The project was approved by Santa Barbara County in October 2008 and is the one before the Commission.

Oil and gas production would be measured as detailed in a "Measurement and Allocation Plan" developed by Commission staff and PXP, and incorporated as part of the Memorandum of Agreement between the Commission, MMS, and PXP. Once measured, it would then be commingled with the federal (Point Pedernales) production and sent to shore in the existing approximately 22 mile 20" emulsion (oil & water) pipeline and 8" gas pipeline (approximately 10 miles of the pipeline is located offshore, a substantial part within Commission lease PRC 6923.1 and 12 miles is located onshore between Surf Beach and the LOGP in Santa Barbara County), then to the LOGP (located approximately 3 miles north of the city of Lompoc) for processing and shipment to a refinery. Oil and gas are sold and distributed via pipelines from the plant. The majority of the produced water is injected onshore at the Lompoc Oil Field with the remaining returned via an 8" water pipeline to Platform Irene for offshore injection. Power is supplied to Irene via a subsea power cable (Commission lease PRC 6911.1) from an electrical substation located on Union Pacific Railroad property at Surf Beach. The substation is connected to the Pacific Gas and Electric power line north of Lompoc.

On September 28, 1997, part of the 20-inch oil emulsion pipeline in state waters (lease PRC 6923.1) ruptured spilling crude oil into the Pacific Ocean about 2-1/2 miles from shore. Oil reached shore at the pipeline break/Surf Beach area. About one mile was considered heavily oiled and moderately to lightly oiled for about four miles. Oil was found coming ashore at Point Arguello. Abalone and seastars were oiled and hundreds of seabirds were killed. Snowy plovers were most affected because they nest at Surf Beach. The oil and cleanup activity displaced the plovers and their shrubs and nesting habitat were trampled or oiled. Collections of sand crabs revealed that they were oiled more than a two mile length of beach. In the days following the spill, the ruptured pipeline was wrapped in fiberglass to prevent further leakage and by November 11, 1997, the pipeline was completely repaired. Studies concluded that the leak was caused by a faulty weld. Soon after the 1997 spill, the operator took several actions to

reduce ongoing corrosion in the oil line, including an aggressive corrosion control program, additional inspections to detect and respond to signs of corrosion, and lowering ("derating") of the maximum allowable operating pressure of the pipeline to address the reduced wall thickness of the pipeline. Annual inspection and regular maintenance of the pipelines, as required by State Lands Commission regulations, and agreed to by the MMS since the spill, have helped ensure the pipeline is maintained and operated safely.

The above mentioned offshore and onshore facilities had been acquired by Nuevo Energy Company and Bellwether Exploration Company in the1990's (collectively referred to as Nuevo). Nuevo proposed a project similar to the project now being considered in 1999; however, in 2002 Santa Barbara County denied approval of the offshore portion of the project and did not certify the EIR, at least with regard to the offshore development. PXP acquired the federal leases and the offshore and onshore facilities from Nuevo in May 2004.

The Point Pedernales project is permitted by Santa Barbara County to process up to 36,000 barrels of dry oil per day (bopd) and up to 15 million standard cubic feet of natural gas per day (mmscfd) (with a maximum hydrogen sulfide concentration level of under 8,000 parts per million (ppm)) at the LOGP. It currently produces around 8,000 bopd and 4.5 mmscfd. According to the EIR, the peak estimated production from the proposed Tranquillon Ridge project will be 27,000 bopd and 5 mmscfd of natural gas.

Well A-28

Pursuant to a Lease Line Well Agreement between the MMS and the Commission dated February 13, 1997, Nuevo drilled "Well A-28" into Federal Lease OCS-P 0441, to a bottom hole location located close to the offshore 3-mile state-federal boundary. Well A-28 was completed in the Monterey formation and has produced over 200,000 barrels (bbls) of oil which makes it one of the poorest producing wells in the federal lease. Initially, the well produced at an oil rate of 800 bopd and 200 thousand standard cubic feet per day (mscfd) of natural gas, although now the amount of oil produced on a daily basis is minimal. Pursuant to the terms of the Lease Line Well Agreement, the State's royalty share in this well is 50% of all hydrocarbons originating within 500 feet of the State/Federal boundary. In addition, because Well A-28 is located within three nautical miles of the state/federal boundary, per the requirements of section 8(g)(2) of the OCS Lands Act (43 USC 1337(g)(2)), the State is entitled to, and does, receive payment of 27% from the federal royalty production of the well.

Onshore Alternative ("Vahevala Project")

Onshore alternatives are primarily limited by the presence of Vandenberg Air Force Base and the air and space operations conducted from that base. Those operations occupy the entire extent of the onshore area from which an onshore oil and gas project could occur. An application to the Commission for a lease by Sunset Petroleum Company and ExxonMobil (collectively referred to here as Sunset) to develop the same state resources as is proposed in this agenda item, but from an onshore site on the Base, has not been deemed complete to date by the County of Santa Barbara due to lack of the surface owner's (United States Air Force) approval for a surface location for the project. Until the statutory requirement of the County is met, the Sunset project application is not considered viable. Although the Commission staff did deem the application complete, the site that was proposed to be used for the project in that application was later denied by the Air Force. Therefore, because the proposed drill site is not available, the project description in that application is no longer valid.

The EIR for PXP's Tranquillon Ridge project did conceptually examine the potential of development from an onshore site similar to what Sunset had proposed for the Vahevala project. The EIR concluded that there is no clear indication that a new onshore drilling and production site would reduce significant impacts associated with the Tranquillon Ridge project, with the important exception of marine resource impacts due to a possible marine oil spill. However, a detailed environmental analysis of a specific Sunset onshore proposal potentially could provide information supporting a different conclusion and might determine that there would likely be a substantial reduction in potential impacts related to a marine oil spill that could outweigh other significant impacts of an onshore project. However, the onshore drilling project would also require a new onshore pipeline and other construction which could cause impacts.

The independent drainage and reservoir study, discussed in greater depth below, considered Sunset's Vahevala project and found it would produce more state oil and gas resources than the proposed project. However, Sunset's project as proposed to the Commission, and evaluated in the drainage study, proposes more wells and has, at a minimum, twice the project life of the Tranquillon Ridge project. These are project elements that are both strongly opposed by local environmental groups and by comments received from the public.

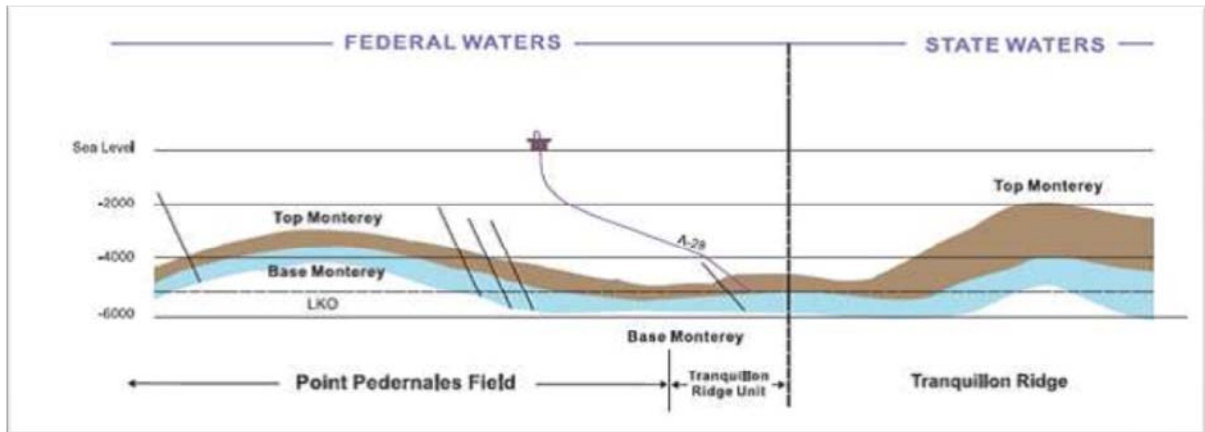
Drainage and Reservoir Studies

To assist the Commission in its determination of drainage, staff contracted with third party engineering and reservoir evaluation services to develop independent determinations of whether drainage was occurring and to estimate the potential of the state resources to be developed. The first study was done in conjunction with the Nuevo application discussed above. The study, done by Allan Spivak Engineering and published in November 2001 (the Spivak study), determined that Well A-28 was on the same structure as the state reservoir and that there was current drainage of hydrocarbons from the state side to the federal side on the structure. The study also confirmed that there was a single aquifer (water drive) under both the Point Pedernales and Tranquillon Ridge structures. The consultant believed, based on his limited observation and Nuevo's information, that drainage of state resources was only occurring by and through the production of Well A-28. The estimated recoverable oil from the state side of the structure was between 100 and 310 million barrels.

With the applications of PXP and Sunset, staff felt that it needed not only an update of the Spivak report (specifically relating to Well A-28 after 10 years of production history), but also a regional picture including whether development from the Point Pedernales field was also causing drainage of state resources. This independent study was conducted by NAFT Consulting in two separate concurrent studies. The first study (Volume I) took a fresh look at the Spivak study, as well as the production history and other geophysical information to update the findings. The second study (Volume II) looked to the regional aspects of the reservoir. Those studies were completed during June-July 2008 and are summarized below.

Volume I: Drainage from the Tranquillon Ridge by Well A-28
The report concludes that Well A-28 has drained and is continuing to drain about 27,000 mcsf per year of natural gas and the associated natural gas liquids from the Tranquillon Ridge structure. The amount of oil being drained is harder to determine for a number of reasons and therefore the study did not conclude whether oil was being drained by this well. The report also concludes that the well is "wasting" the state's reservoir energy from that area and thereby damaging the potential oil and gas recovery from the state resources. As illustrated below, this is because the Tranquillon Ridge field is part of a continuous geologic structure that also includes the federal Point Pedernales field and includes a "saddle" structure with a common aquifer. That saddle structure allows the federal lease to fully make use of the shared common aquifer to drive the production of federal oil and gas, lessening the available energy (pressure)

for any future production of state oil and gas resources. The report estimates that over 1.4 million barrels of recoverable oil from the state-owned portion of Tranquillon Ridge may have already been jeopardized.



The second finding of Volume I is that the state Tranquillon Ridge field conceivably has up to 170-180 million barrels of recoverable oil. However, even disregarding the loss of reservoir energy, the recoverable oil from this Tranquillon Ridge project, due to the proposed December 2022 lease end date and less than optimum well trajectories encountering the Monterey (producing formation) fracture systems from Platform Irene, may only be in a range of 40-90 million barrels of oil.

Volume II: Drainage of the Tranquillon Ridge Prospect by the Point Pedernales Oilfield

Volume II is an extension of the Volume I report on the oil and gas reserves in the Tranquillon Ridge geologic structure, but with a broader focus on potential drainage by the operation of the Point Pedernales oilfield in general, and from the perspective of the potential project to develop the field from an onshore drillsite (as submitted by Sunset Exploration and ExxonMobil Corp, aka the “Vahevala Project”). The same data sources and reports used and consulted in preparation of Volume I were used for the preparation of this report with the exception of additional independent seismic interpretation and other information specifically from the Vahevala proposal.

Based on further analysis of seismic data and diagnostic mapping of performance data the report finds that Point Pedernales production has benefitted from a common aquifer shared with the Tranquillon Ridge structure as

reported in Volume I, and has drained substantial natural water drive energy causing long term recovery losses for any future potential Tranquillon Ridge operations in state waters. Continuation of Point Pedernales operations, with no correlative state development project, is putting at risk about 260,000 barrels of recoverable state oil reserves per month due to the loss of reservoir energy.

Under the Vahevala development proposal, where 30 wells were planned to produce within a 30 year operational life, the study estimates the recoverable oil to range from 100 to 150 million barrels of oil, plus the associated natural gas and natural gas liquids.

Volume III: Addendum (and Summary) of Drainage Studies
Volume III summarizes that the geologic structure that includes both the Point Pedernales and Tranquillon Ridge fields is one oilfield consisting of a number of fault blocks, connected by the “saddle” area near the state/federal boundary. The development of Point Pedernales has resulted in substantial movement and migration of oil and gas and depletion of reservoir energy from the Tranquillon Ridge. Based on the geological, geophysical and production data, including that from Well A-28, the report does not see a discontinuity between the Point Pedernales and the Tranquillon Ridge fields. In other words, they are both part of the same oilfield and the division between federal and state ownership does not mirror the reservoir boundary.

Modifications to Existing Infrastructure

The project as proposed would require only minor modifications and upgrades to the existing drilling and production infrastructure. The project would require installing new shipping pumps on Platform Irene. The three existing 600-hp electrical shipping pumps would be replaced with three 1,250-hp electrical shipping pumps. In addition, approximately eight of the new Tranquillon Ridge wells would utilize new 300-900 hp electrical submersible pumps. The other production wells would utilize gas-lift technology. Ongoing maintenance and upgrades of the electrical transformers and switchgear on the platform for these additional pump loads has already begun.

Drilling activities and equipment would be similar to those of current and ongoing drilling programs, but with somewhat different frequency and duration. The existing drilling rig on Platform Irene would be used to drill the project wells. The only additional equipment for drilling would be a new 1,600-horsepower electric pump for handling drilling fluids, as well as some refurbishing of the existing

drilling fluids system. It is possible, due to new technology or improved rig efficiencies, that in the future, a new drill rig could be used to drill some of the later wells in the project

The existing 8-inch produced water return pipeline is currently used to return a portion of the Point Pedernales produced water from the LOGP to Platform Irene for offshore water injection (a portion of the produced water is also injected onshore into the Lompoc Oil Field). For the proposed development, part of the produced water would continue to be transported offshore. Produced water would continue to be injected offshore or onshore in accordance with permitting agency authorizations. Approximately 40,000 bpd of water produced from Point Pedernales and Tranquillon Ridge combined would be shipped from the LOGP to Platform Irene for injection. The operator’s current federal Clean Water Act National Pollutant Discharge Elimination System (NPDES) permit authorizes some ocean discharge of the produced water, however the proposed lease provisions would disallow such use except in an emergency.

Environmental Impact Report

Under the California Environmental Quality Act (CEQA, see also California Code of Regulations, Title 14), it was determined that Santa Barbara County (County) was the appropriate lead agency for this project. As such, the County commissioned both the Draft and the Final Environmental Impact Reports (EIR). The Commission staff along with the California Coastal Commission staff provided oversight in the preparation of the EIR through a Joint Review Panel Memorandum of Understanding. The Minerals Management Service, Vandenberg Air Force Base, and Santa Barbara County Air Pollution Control District were also part of the Joint Review Panel as advisory agencies. The EIR was certified on April 21, 2008, by the County Planning Commission. This action was appealed to the County Board of Supervisors, the appeal was denied, and the EIR was certified by the County Board of Supervisors on October 7, 2008. The time for any additional legal challenges to the EIR has passed. The Commission staff has reviewed the EIR and Mitigation Monitoring Program adopted by the lead agency. Exhibit G-2 sets forth the Mitigation Monitoring Program.

The EIR identified eleven significant and unavoidable (Class I) impacts as the result of the reduced-life project. These impacts result from the increased volumes of oil and gas over current production levels and are primarily related to marine oil spills or trucking of hazardous materials on local roadways. Issue area

impacts include marine and terrestrial biological resources and water quality, fishing, recreational, and cultural resources due to the risk of oil spills and spill clean-up efforts, and significant public safety risks associated with truck transport of gas liquids from the Lompoc Oil and Gas Plant.

The County made Findings in conformance with the State CEQA Guidelines (Title 14, California Code of Regulations, sections 15091 and 15096) and is provided in Exhibit G-1. Due to the Class I impacts as a result of the project, the County also made a Statement of Overriding Considerations in conformance with the State CEQA Guidelines (Title 14, California Code of Regulations, section 15093) and is provided in Exhibit G-3.

The Commission staff also held a hearing on the Draft EIR for the proposed lease in the city of Santa Barbara. The public hearing, held on November 13, 2007, provided an additional opportunity for representatives of fishermen operating within the area being considered for leasing, representatives of the oil industry, and other members of the public to submit additional comments on the Draft EIR related to the protection of, and potential impacts to, fisheries and marine habitat within the area being considered for leasing. No additional comments were received at the public hearing. The National Oceanic and Atmospheric Agency’s (NOAA) National Marine Fisheries Service (NMFS) submitted comments with regard to essential fish habitat (EFH), marine mammals, and federally listed species (letter dated March 6, 2008). NOAA’s only recommended conservation measure for EFH was to avoid discharging drill muds, cuttings, and produced water into ocean waters. The recommendation was to require that the “applicant should either inject into an underground formation or dispose of the materials onshore.” Although Public Resources Code Section 6873 provides that disposal of cuttings and muds may be authorized in accordance with permits from the Regional Water Quality Control Board, the Commission has the authority to prohibit a lessee from discharging any muds and cuttings into ocean waters. NOAA’s recommendation was not incorporated into the final EIR or into the terms of Santa Barbara County’s permit; however, staff is recommending that any lease require PXP to comply with NOAA’s recommendation.

Environmental Benefits Enforcement

PXP-EDC Agreement

On April 10, 2008, PXP and the Environmental Defense Center (EDC) representing itself, Get Oil Out! (GOO) and the Citizen's Planning Association of Santa Barbara announced an agreement (PXP-EDC agreement) that would allow the environmental groups to actively support the development of Tranquillon Ridge by PXP. That these three groups, especially GOO, which was formed in response to the 1969 oil spill, were able to reach an agreement with PXP is especially noteworthy as they have all been staunchly opposed to any oil and gas development. Although this is a private confidential agreement, its parties agreed to provide copies to specified Commission staff. For the agreed environmental benefits to occur EDC must assist PXP in obtaining all necessary approvals for the Tranquillon Ridge project and the project must produce oil and gas and be commercially viable. The environmental benefits can be roughly described as comprising three categories: end dates for PXP's offshore oil and gas operations and onshore processing facilities in Santa Barbara County, land conveyance commitments by PXP, and green house gas mitigation measures.

The first proposed benefit, cessation of offshore oil operations by a date certain, focuses on those aspects of oil and gas production that PXP has control over within and adjacent (in the OCS) to Santa Barbara County. There are two groupings of projects that make up this proposed benefit. The first comprises the Point Pedernales project located in federal waters, the proposed Tranquillon Ridge project located in state waters, Platform Irene located in federal waters, the pipeline between Platform Irene and the Lompoc Oil and Gas Processing facility (LOGP) located in federal and state waters and onshore, and the LOGP itself located in Santa Barbara County; the second grouping is comprised of the Point Arguello project in federal waters, with its associated platforms and pipelines (including Commission lease PRC 6942.1 and 6943.1 in state waters), and the processing facility in Gaviota. Production of oil and gas from those facilities related to Point Pedernales and Tranquillon Ridge is to end by December 31, 2022; production from those related to Point Arguello is to end in 2017. By their respective end dates, PXP is to begin the application processes with the appropriate government entities to decommission and remove the facilities involved in those projects. By providing a fixed end date for the operations that currently are able to operate indefinitely, the PXP-EDC agreement seeks to have the long-term risks to the environment from oil spills lessened and to end a significant amount of production of oil and gas from state and federal waters.

The second proposed benefit, the land conveyances from PXP to the Trust for Public Land (TPL), details of which are apparently provided for in a separate private confidential agreement that has not been provided to staff and therefore cannot be confirmed or reviewed, is to be done in phases. It has been stated that TPL intends to ultimately transfer the land to state agencies to ensure that the land is protected in perpetuity. Specifically, if certain events take place PXP is to donate in phases: 1) up to 3,700± acres (Lompoc Lands) adjacent to, and intended to be operated with, the existing 5,300 acre Burton Mesa Ecological Reserve (operated by the Department of Fish and Game (DFG) pursuant to Commission lease PRC 8129.9, 2) three parcels totaling approximately 200 acres along the Gaviota coast including the land under the Gaviota processing facility and the Smith and Sunburst parcels. Currently, some processing facilities exist on portions of two of the four parcels, so some areas will likely require remediation work. The conveyances have a two part anticipated environmental benefit – the addition of new open space lands, both coastal and inland, and the prevention of the construction of a large scale housing development in an environmentally sensitive area on a portion of the Lompoc Lands. Without this agreement, only the 30 acres of the land that PXP is already required to convey to the DFG for mitigation of a previous project is to be protected and the rest would be subject to possible development. It is suggested that the conveyance of lands underlying the processing facilities is, in addition to end dates, another mechanism to insure shutdown of the offshore operations.

The final category is Green House Gas (GHG) mitigation. PXP is required to reduce or offset (1:1) all of the GHG emissions from the Tranquillon Ridge project. This is to be done in two phases, both relying on an independent third-party auditor. Phase one occurs at the beginning of the project and looks to see what feasible measures can be done to eliminate or reduce the generation of GHG from ongoing drilling and production on the platform. The second phase occurs annually for the life of the project and requires PXP to purchase offsets for any remaining GHG that is above the current, pre-Tranquillon Ridge baseline. In addition, PXP will donate $1,500,000 to Santa Barbara County for the reduction of GHG emissions by such mechanisms as purchasing alternative fuel transit buses. The mitigation of GHG is an important issue, but the best mechanisms to achieve full mitigation are not clear. The California Legislature passed AB 32 in 2006, requiring that GHG emissions be reduced to 1990 levels by the year 2020; however, the regulations to implement AB 32 are not yet in place. The GHG mitigation measures and framework to which PXP is agreeing, may or may not be stricter than what the state ultimately creates, but in the absence of this

agreement the GHG emissions currently generated by the operations at Platform Irene in federal waters are not likely to be mitigated any time in the near future, if ever.

California State Lands Commission's Ability to Enforce Benefits

The Commission staff has analyzed the environmental benefits of the PXP-EDC agreement because they appear to provide a basis for determining whether the proposed leases are in the best interest of the state. After consultation with the Commission, staff looked for ways to include requirements in the proposed leases or as conditions of Commission approval that would give the Commission the ability to mandate and implement the same benefits as were contained in the PXP-EDC agreement.

In consultation with the Attorney General's office, staff attorneys concluded that the goals of the agreement could not be reliably enforced and that the legal context for the public benefit requirements of the agreement prevented staff from devising mechanisms to improve enforceability.

The confidentiality agreement, required by EDC and PXP before staff could review the PXP-EDC agreement, prevents disclosure by staff of specific provisions of the PXP-EDC agreement. However, staff can discuss the legal barriers to including legally enforceable provisions in the Commission's leases. Staff has looked at several options including: 1) PXP could be required through lease provisions to halt oil production from the federal leases by the PXP-EDC agreement end dates; 2)The state could negotiate an agreement with MMS wherein the federal government would agree not to litigate PXP's closure of federal lease production from Point Pedernales and Point Arguello; 3) The State could refuse to extend the leases of state lands for the pipelines and power lines that serve the federal platforms; 4) The State could require that the onshore facilities be closed down consistent with the end dates; and 5) The state could impose "backstop" requirements in the leases that would assure that the land dedications contemplated in the EDC agreement would occur.

Commission staff has concluded that the Commission cannot reliably require PXP to stop and close production on federal leases for several reasons. First, to do so could tortuously interfere with the contracts between PXP and MMS involving the federal leases. Most observers would agree that commercial oil production at Point Arguello and Point Pedernales will have declined when the respective end dates of 2017 and 2022 are reached. However, EDC believes

there is a public benefit to these end dates because commercial production may extend beyond any a date anticipated date set 8 or 14 years in advance. Oil prices typically increase over time, enabling more costly recovery mechanisms to be employed to recover additional oil. New technology also allows more oil to be recovered. Absent the PXP-EDC agreement or similar lease conditions, commercial oil production at these two areas is likely to continue past the end dates with continued revenues for the federal government. A contract which causes PXP to prematurely abandon oil production and which halts anticipated revenue could cause the federal government to litigate against the state for damages and against PXP for either damages or continued production of the federal leases. Commission requirements to close onshore processing facilities at Gaviota and Lompoc are subject to the same legal challenges.

The federal government could also exercise its condemnation or eminent domain powers to keep open the onshore production facilities and to prevent the state from closing down the pipelines which service the federal leases. Although it is likely that this would only occur under certain economic scenarios, the federal government has exercised these powers to take control of sovereign land on previous occasions. That these pipelines and facilities are necessary for interstate commerce, the primary requirement for a condemnation or eminent domain proceeding has already been answered. In the 1980’s, the Commission has heavily involved in litigation that arose out of the Commission’s decisions to alter how the rental rate for the pipeline leases was established. The result of the litigation was that an oil industry association successfully relied on the Commerce Clause and the Import-Export Clause of the United States Constitution to stop the Commission from imposing a throughput based royalty. The oil industry association argued that the Commission has a monopoly over the land between the federal offshore oil and the onshore processing facilities and pipelines and that because oil and gas falls within interstate commerce, the Commission’s discretionary power is tempered by the United State Constitution. The United States Court of Appeals Ninth Circuit agreed and held that the Commission, by raising its pipeline rates, was violating the Commerce Clause by disrupting the free flow of interstate commerce and the Import-Export Clause by obtaining money that other non-coastal, non-oil rich states cannot obtain. *Western Oil & Gas* Ass*ociation v. Cory*, 726 F.2d 1340 (1984), petition for rehearing denied in *Cory v. Western Oil and Gas Association*, *471 U.S. 1112* (1985). The state could be similarly vulnerable to federal intervention if the state tried to stop use of the pipelines for conveying the federal oil. The United States has recently condemned rights-of-way across state submerged lands.
The MMS has evinced no interest in agreeing to the end dates. In a March 10,

2008 letter, it indicated that its conservation goal remains to recover the oil and gas reserves in the Point Pedernales field. MMS indicated to PXP that it would refuse to approve a Development and Production Plan (DPP) for use of Platform Irene for Tranquillon Ridge if it included an end date for the federal leases. MMS also refused to have an end date in the Plan for production of Tranquillon Ridge. MMS has no incentive to give up the federal production. Further, in *Tucson Airport Authority v. General Dynamics; General Dynamics v. William Perry, Secretary of Defense; Sheila Widnall, Secretary of the Air Force; United States of America*, 136 F.3d 641 (1998) the United States Court of Appeals Ninth Circuit held that the federal government could be sued for damages only, not performance. Thus, if MMS entered into an agreement to end production in federal leases and chose not to implement it, California could only litigate for damages and not to obtain cessation of oil production; the potential policy basis for approval of the Tranquillon Ridge leases would therefore not be obtainable through litigation.

Further, the ability of PXP to seek MMS approval of the end dates for the federal leases may be hampered by whatever partnership agreements are in place for the Gaviota facility and the existing federal offshore leases. Staff has not been given a copy of those partnership agreements.

Staff also considered developing a lease provision in which PXP would agree to pay the state a large penalty should the federal lease end dates not be realized. However, a payment to the state would not obtain the public policy result desired – closure of the federal leases. Further, courts have declined to enforce liquidated damage provisions where the intent is to establish a penalty through the provision to obtain the desired performance. Instead, courts have limited payments to actual demonstrated damages. Establishing a monetary damage amount for failure to close a federal lease would be difficult, if not impossible.

With respect to the onshore land donations contemplated in the PXP-EDC agreement, these would not be hampered by the same legal considerations as enforcement of the federal end dates (with the exception of the relatively small acreages, which are the sites of the two processing facilities). However, PXP and EDC have refused to share the separate land donation agreement with TPL that specifies how the land would be donated. Timelines, remediation, title resolution etc. are not well spelled out in the PXP-EDC agreement. Staff asked if EDC and PXP could indicate outside parameters for conclusion of the land donations pursuant to the confidential TPL agreement. Staff contemplated developing a lease provision that would provide for donation of the lands to an

entity of the Commission's choice if the transfer had not occurred, for example, within ten years after the end dates.

In response to staff raising these issues, counsel for PXP provided a memo (Exhibit "I") advocating that the Commission not try to enforce the Point Arguello end dates and the land donations, but to focus on Point Pedernales and the GHG emissions. Among other things, the memo suggested that the donations could take a long time to complete and that title problems could prevent some of the donations from occurring at all. Without knowing the mechanics and nature of the donation process, staff could not draft backstop provisions without potentially conflicting with the PXP-EDC agreement.

Staff reviewed the GHG emission provisions and found that PXP probably will not reach the announced goal of reducing or offsetting all of the GHG emissions from the project. First, a portion of the mitigation will occur through the purchase of offsets. The agreement sets the price to be paid for offsets at $10 per ton. In 2008, the Commission rejected an identical cap proposed on offset costs by Poseidon for its GHG mitigation program for its Carlsbad desalination facility because it could result in insufficient mitigation.

Staff research indicates that the current cost of offsets is about $7.30 per ton but that the price has fluctuated. In the future the price of offsets may exceed $10/ton. If so, the proposed program may not mitigate the full impacts. Second, the material submitted by PXP and the information contained in the Final EIR indicate that the mitigation is only for direct GHG emissions and that there is no mitigation proposed for the GHG emissions associated with the electricity used for well drilling, well lifting pumps and water reinjection. The Poseidon project emissions were largely composed of those associated with generation of the electricity used in the desalination process. While the exact amount of electricity for well drilling, well lifting pumps and water reinjection to be used by the Tranquillon Ridge project is not well defined, Commission staff estimates it to be roughly 424,274 megawatt hours (MWh) over the life of the project. Using the average carbon emissions of .456 pounds/kilowatt hour associated with generation by PG&E, the source of the power to be used for Tranquillon Ridge, this totals 87,741 tons over 14 years or an average of approximately 6,500 tons per year. Staff has attached supplemental provisions (Exhibit G-4) that would require all production and development resulting in GHG emissions associated with the Tranquillon Ridge project to be mitigated, should the Commission chose to approve the leases and want to improve PXP's proposed GHG mitigation. PXP's GHG emission plan assumes that offsets can be purchased at $10 per ton

and plans to mitigate 14,925 tons per year of direct emissions. PXP argues that there is a significant indirect effect of importing oil and gas into California and producing California oil results in a significant reduction in toxic and GHG emissions from displaced tanker trips (estimated by PXP to be 93,110 tons per year). Further, PXP argues that those reductions combined with the reductions generated from the Hybrid Bus Program to be created by the County with the $1,500,000 donated by PXP, results in a net negative GHG emission of both direct and what could be described as indirect GHG emissions.

In conclusion, staff does not believe the PXP-EDC agreement forms a reliable basis for a determination that the project is in the best interest of the state as required by Public Resources Code Section 6244. Enforcement of the federal end dates is uncertain and the GHG mitigation appears incomplete. The land donations may provide a significant public benefit but without access to the land donation agreement, staff cannot confirm this.

Santa Barbara County Permit Conditions

Santa Barbara County approved the Tranquillon Ridge project in October 2008, certified the final EIR, adopted a Statement of Overriding Considerations, and issued a Revised Development Permit. The County permit incorporates only the GHG mitigation and end date provisions of the proposed Tranquillon Ridge oil and gas lease as set forth in the PXP-EDC agreement. The end date provides that production of oil and gas from the Tranquillon Ridge project is to cease by December 31, 2022. The permit also included the same GHG mitigation terms contained in the PXP-EDC agreement. While the County initially indicated that it would attach the same end date to the LOGP facility, it ultimately did not. The County end dates do not otherwise enforce the federal lease end dates

California Coastal Commission Conditions of Approval

The California Coastal Commission (CCC) is the final state government entity that will evaluate the Tranquillon Ridge project. It must make a consistency finding for the revised Development and Production Plan submitted to the MMS and issue a Coastal Development Permit to PXP. The CCC is tentatively scheduled to hear the item on February 5, 2009. Key features of the project that CCC will evaluate are: no more than seventeen wells drilled into state lands, the same GHG mitigation that is before the Commission in this Calendar Item, the December 31, 2022 end date for the state Tranquillon Ridge project and potential for oil spills. CCC staff does not intend to recommend enforcement of the federal

end dates.

Mineral Management Service Jurisdiction

The Mineral Management Service (MMS) is the branch of the federal Department of Interior charged with managing the federal government's offshore oil and gas resources. If the Commission approves the Tranquillon Ridge project, the MMS will need to issue a Right of Use and Easement (RUE). This must be done to allow PXP to utilize Platform Irene to access the state resources as contemplated in the Tranquillon Ridge project. This action by the MMS is a discretionary action, so Commission staff cannot inform the Commission with absolute certainty what the MMS will do. It is more likely than not that MMS will decide to issue a RUE, but it is almost certain that the MMS will not agree to include any end dates in a RUE. The MMS will also need to approve a revised Development and Production Plan (DPP) for the use of Platform Irene in developing Tranquillon Ridge. While sharing of the oil revenues with the MMS was an issue in earlier negotiations regarding a unit agreement, since some of the resource underlies federal land, the use of a RUE would eliminate any need for such sharing. When this staff recommendation was prepared, the terms of the RUE were not known. The remaining issue of concern to staff is potential control of the drilling operations into state waters. MMS has a legitimate cause for reviewing these operations because they could interfere with production from the federal leases. However, staff believes the RUE should include a process that allows for reasonable operation of the state leases. Staff recommends that any Commission approval of the proposed leases be conditioned upon subsequent Commission approval of the RUE before drilling commences.

Proposed Lease Terms

The royalty rate agreed to by PXP for oil and gas production from Tranquillon Ridge is defined by the chart in Exhibit F. This sliding scale royalty rate increases with increasing oil price and decreases with decreasing oil prices. At $100/barrel, the royalty rate to the state would be 48% and the total revenue to the state if the full, optimistic estimate of 90 million barrels of oil equivalent is produced would be approximately $4.2 billion over 14 years. At the current oil price of approximately $34 per barrel, the royalty rate is 25% and the total revenue would be approximately $750 million. This is the highest royalty rate structure in any oil and gas lease known to staff.

To help assist with current state fiscal problems, PXP has agreed to pre-pay

$100 million of the royalty due the state when the first well is drilled. This also represents about a quarter of one percent of the anticipated state deficit of $41.6 billion over the next 18 months.

Several provisions remain unresolved at the time of this staff report. First, agreement has not yet been reached on the amount for reimbursement of staff expenses for inspecting, monitoring and auditing the Tranquillon Ridge operations and leases. Second, staff has asked for a performance bond to cover two months of royalty. The latter would not be required until after the state had accumulated the royalty credit to offset the prepayment of $100 million. Third, because of staff's experience with lessees manipulating the sales price of state minerals to reduce the royalty, staff is negotiating using a price based “floor” on a bench mark, such as percentage of West Texas Intermediate Crude. The benchmark would have an adjustment factor to reflect differences in oil quality. Final agreement has not been reached on the benchmark percentage yet. Finally, the applicant has yet to agree to inject muds and cuttings or dispose of them on land rather than dumping them from the platform under their NPDES permit. Dumping would be allowed in case of emergency, but only for a short period of time related to safety and only if PXP complies with the NPDES issued by the Regional Water Quality Control Board during that time.

Provisions agreed to include requiring the applicant to drill a minimum of three wells in the first two years of the lease, and rentals of$100/acre until the leases produce (this equals around $1 million for the total acreage) and, reducing to $10/acre during production.

Resolved Lease Terms	**Unresolved Lease Terms**
Royalty (Price based sliding scale)	Disposal of Muds, Cuttings and Produced Water
Pre-paid Royalty Payment	Lease Management Fee
Lease Descriptions	Bond Amounts
Drilling Term	Oil Price “Floor”
Rent	Constructive Transfer Clause
Severance Tax Offset	Drill-string Requirement (requirement for time and economics for continued drilling)
Measurement & Allocation	
Regulation & Inspection	

Best Interest of the State

As indicated above, based on studies performed in 2008, staff believes that drainage of state gas and oil is occurring and that this requirement for issuing a new state lease has been met. Determining whether the proposed leases are in the ***best interest of the state*** as required by Section 2144, is a more difficult matter because there are good arguments on both sides of the issue. Below is a summary of the considerations known to staff. Ultimately, determining if this project is in the state's best interest is a policy decision for the Commission and it may consider factors other than those listed.

As discussed above, staff believes that the PXP-EDC agreement provides some basis for this determination only because of the land donations, and staff does not have the necessary details to verify the efficacy of the agreement in this regard. The end dates for federal lease production at Point Arguello and Point Pedernales cannot be assured. The GHG emission mitigation program does not appear to meet its goal of eliminating new emissions from production at Tranquillon Ridge. Even if the Commission adopts lease provisions to improve the GHG mitigation program, the result will not be a public benefit, but only the mitigation of a potential burden.

The new revenues that could come to the state from Tranquillon Ridge are potentially large. They will not provide a significant contribution to reducing the fiscal deficit, but they could play a part. In the past, legislation required that oil revenues be used primarily for the state's water program and higher education, and secondarily for the Veterans' Dependants Education Fund, Small Craft Harbors Revolving Fund, Beaches and Parks Fund, the State Soil Conservation Commission for soil conservation and flood control, Division of Forestry and other public priorities. Now the revenues go into the General Fund.

The drainage of oil and gas merits some consideration. The loss of water energy because of the Point Pedernales production is more significant. Annually, more state oil and gas is being lost to future potential production from loss of water energy, even though the oil and gas remains on state property, than from drainage of state oil and gas into federal lands. The drainage of this energy is not considered drainage by the statute but can be considered by the Commission when determining "best interest of the state."

The drainage provisions of the state's Coastal Sanctuary Act are intended to preserve state oil and gas resources in cases where they are being drained by wells in federal waters. However, pursuant to the Act and the Commission's own

administrative moratorium on new leases, none of this oil and gas is currently contemplated for recovery. The resolutions adopted by the Commission over the last eight years all are dedicated to the proposition that California is better off if oil and gas remains undeveloped. In adopting the resolutions, the Commission determined that environmental, tourism, recreational, economic, fishing, scenic and other values are threatened by offshore oil development and that these values were more important.

These resolutions are generally directed at opposing proposals for new federal leases. They hold up the state's refusal to issue new leases as an example that should be followed by the federal government in waters off of California. Recently, the potential for new federal leases off California has significantly increased. In the fall of 2008, President Bush, by executive order, lifted the presidential moratorium that had been in effect since 1990. Additionally, Congress has to date refused to re-enact its own moratorium that expired last year. On January 16, 2009, the Department of Interior announced plans to conduct lease sales in different parts of the country including three off of California – off Santa Barbara County, San Juan Capistrano and Mendocino County.

Based on the inconsistency of the Tranquillon Ridge projects with the Commission's previously enunciated policies on offshore oil and gas leasing and the impact a new lease would have on the potential for new federal leasing off of California, staff recommends that the Commission find that the proposed leases are not in the best interest of the state and are, therefore, inconsistent with Section 6244 of the Public Resources Code and disapprove the proposed leases.

Should the Commission determine that the proposed leases are in the best interest of the state, staff has prepared an alternate set of findings attached as Exhibit G.

PERMIT STREAMLINING ACT DEADLINE:

April 7, 2009

EXHIBITS:

A-1 Land Description of the "north" lease
A-2 Land Description of the "south" lease
B. Site Map
C. Proposed Lease Forms

D. Memorandum of Agreement: Measurement & Allocation Plan
E. Memorandum of Agreement: Inspection and Regulatory Protocols
F. Royalty Rate Chart
G. Alternative Commission Findings for Approving Leases to PXP
G-1 CEQA Findings for Alternative Commission Findings
G-2 CEQA Mitigation Monitoring Program for Alternative Commission Findings
G-3 CEQA Statement of Overriding Considerations for Alternative Commission Findings
G-4 Supplemental GHG Mitigation Measures
H. Previous California State Lands Commission Resolutions
I. Memo from PXP to Commission Staff
J. Illustration of Relation Between Federal and State Resources Tranquillon Ridge Field

RECOMMENDED ACTION:

IT IS RECOMMENDED THAT THE COMMISSION:

FIND AND DETERMINE, PURSUANT TO CALIFORNIA PUBLIC RESOURCES CODE SECTION 6244, THAT THE PROPOSAL TO LEASE STATE-OWNED SUBMERGED LANDS IN THE CALIFORNIA COASTAL SANCTUARY IS NOT IN THE STATE'S BEST INTEREST; AND, DENY THE APPLICATION BY PLAINS EXPLORATION AND PRODUCTION COMPANY FOR THE LEASING OF STATE-OWNED SUBMERGED LANDS.