

CALENDAR ITEM

66

A 35

PRC 7911.1

PRC 4000.1

M. Voskanian

S 18

J. Planck

**CONSIDER FINDING CARONE PETROLEUM CORPORATION
IN DEFAULT OF SUBSURFACE (NO SURFACE USE)
OIL AND GAS LEASE NOS. PRC 7911.1 AND PRC 4000.1,
OFFSHORE CARPINTERIA,
SANTA BARBARA COUNTY**

LESSEE:

Carone Petroleum Corporation
Attn.: Mr. Charles W. Cappel, President
1145 Eugenia Place, Suite 200
Carpinteria, CA 93013

AREA, LAND TYPE, AND LOCATION:

Oil and Gas Lease No. PRC 7911.1 contains approximately 1,541 acres of submerged land, which originally comprised the southern portion of Oil and Gas Lease No. PRC 3150.1, and Oil and Gas Lease No. 4000.1 contains approximately 204 acres of submerged land. Both are offshore Carpinteria, Santa Barbara County, California.

BACKGROUND:

The original Calendar Item for the Commission public meeting on April 9, 2009, containing the entire background and history for the staff recommendation for finding Carone Petroleum Corporation (Carone) in default of Oil and Gas Lease Nos. PRC 7911.1 and PRC 4000.1, for failure to diligently pursue returning those leases to production, is incorporated by reference and can be found attached as Exhibit "F" to this Calendar Item.

UPDATE:

This item was heard by the Commission at its public meeting held on April 9, 2009. The Commission, after considering the staff report, and the testimony of staff and Carone's representatives, continued the matter to its June 1, 2009, meeting. The Commission instructed Carone to complete the following before

CALENDAR ITEM NO. 66 (CONT'D)

that meeting:

1. To complete the structural evaluation of platform Hogan pursuant to the MMS requirements regarding platform requalification with the use of an independent third party Certified Verification Agent (CVA) acceptable to the MMS and Commission staff, to report the results of the evaluation, and, if incomplete, to have the CVA testify to the Commission on June 1, 2009, as to why the report is not complete;
2. To file, in sufficient form and content, an application with the MMS for approval of a Right of Use and Easement (RUE) agreement in order to procure the right to drill from federal platform Hogan into the state leases; and,
3. To execute and fully fund a reimbursement agreement in the amount of \$650,000.00 with the state to cover the costs of an Environmental Impact Report and estimated staff costs, for the purposes of processing and considering the application on file with the state for the project of developing and producing from state oil and gas leases PRC 7911.1 and PRC 4000.1, in the Carpinteria Field.

The Commission further indicated that if Carone failed to complete all three tasks without acceptable reasons sufficiently outside of the control of Carone, the Commission would then accept the staff recommendation and find Carone in default of State Oil and Gas leases PRC 7911.1 and PRC 4000.1. Carone would then have 90 days to cure the default or lose the leases.

Since the April 9th meeting, Carone has been diligently trying to achieve the Commission's requirements.

- (1) With respect to the first requirement, Carone nominated, and on May 6, 2009, the MMS accepted the nomination of Peter Marshall as a Certified Verification Agent (CVA) to review the structural analysis for Platform Hogan and determine whether it could be "re-qualified" under the federal statutes and American Petroleum Institute standards. This nomination of Peter Marshall is also acceptable to Commission staff. The CVA has been in constant contact with Carone's structural consultant and Carone submitted a copy of its final report to the MMS and the CVA on May 24, 2009. Carone has informed Commission staff that the CVA will submit his report to the MMS prior to June 1, 2009. The MMS estimates that the time for its acceptance and approval to be 30-90 days.
- (2) With respect to the second requirement, Carone hired a consultant who

CALENDAR ITEM NO. 66 (CONT'D)

has been in contact with the MMS regarding the resubmittal of Carone's expanded and detailed RUE application, including appropriate responses to comments by MMS in its letter of February 2008 citing deficiencies in Carone's initial submission. Carone has informed Commission staff that its application will be resubmitted prior to June 1, 2009. In a conversation with Commission staff, the MMS believes that it will be able to respond to that re-submission within 30 days (although there is no statutory time limit).

- (3) With respect to the third requirement, Carone has informed Commission staff that they are attempting to secure, and expect to close a deal with a funding source to enable the submittal of the \$650,000.00 in reimbursement funds and the executed reimbursement agreement for re-starting the CEQA process on or before June 1, 2009.

STATUTORY AND OTHER REFERENCES:

Public Resources Code Sections 6827 and 6829 and Lease Paragraphs 1 and 6

OTHER PERTINENT INFORMATION:

1. Pursuant to the Commission's delegation of authority and the State CEQA Guidelines [Title 14, California Code of Regulations, section 15060(c)(3)], the staff has determined that this activity is not subject to the provisions of the CEQA because it is not a "project" as defined by the CEQA and the State CEQA Guidelines.

Authority: Public Resources Code section 21065 and Title 14, California Code of Regulations, sections 15060 (c)(3) and 15378.

2. This activity involves lands identified as possessing significant environmental values pursuant to Public Resources Code sections 6370, et seq., but such activity will not affect those significant lands.

Authority: Public Resources Code sections 6370 et seq.

EXHIBITS:

- A1. Land Description – PRC 7911.1
- A2. Land Description – PRC 4000.1
- B. Location Map
- C. Staff's September 2008 Letter
- D. Carone's January 2009 response to Staff's Letter
- E. Staff's February 2009 Letter
- F. Calendar Item from the April 9, 2009 Commission Meeting

PERMIT STREAMLINING ACT DEADLINE:

N/A

RECOMMENDED ACTION:

IT IS RECOMMENDED THAT THE COMMISSION:

CEQA FINDING:

1. 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) BECAUSE THE ACTIVITY IS NOT A PROJECT AS DEFINED BY PUBLIC RESOURCES CODE SECTION 21065 AND TITLE 14, CALIFORNIA CODE OF REGULATIONS, SECTION 15378.
2. FIND THAT THIS ACTIVITY IS CONSISTENT WITH THE USE CLASSIFICATION DESIGNATED BY THE COMMISSION FOR THE LAND PURSUANT TO PUBLIC RESOURCES CODE SECTIONS 6370, ET SEQ.

AUTHORIZATION:

A: AS OF MAY 27, 2009 (THE DATE OF THIS WRITING), THE THREE ACTIONS REQUIRED BY THE COMMISSION TO BE COMPLETED BY THE JUNE 1, 2009 MEETING ARE STILL INCOMPLETE. THEREFORE, THE STAFF RECOMMENDS THE COMMISSION ISSUE THE FOLLOWING AUTHORIZATION BASED ON THE REASONS SET FORTH IN THE APRIL 9, 2009 STAFF REPORT (AND ATTACHED HEREWITH AS EXHIBIT F):

1. FIND CARONE PETROLEUM CORPORATION, AS LESSEE, IN DEFAULT UNDER THE OBLIGATIONS OF OIL AND GAS LEASE NOS. PRC 4000.1 AND PRC 7911.1, FOR FAILURE TO PURSUE WITH DILIGENCE THE DEVELOPMENT OF THOSE LEASES
2. DIRECT STAFF TO ISSUE A DEFAULT NOTICE THAT WILL PROVIDE THAT IF THE DEFAULT IS NOT CURED BY FULLY COMPLYING WITH THE THREE DEMANDS SET FORTH IN THE STAFF LETTER OF SEPTEMBER 30, 2008, WITHIN NINETY (90) DAYS OF THE DEFAULT NOTICE, THE LEASES SHALL BE FORFEITED AND CANCELED.

CALENDAR ITEM NO. 66 (CONT'D)

3. DIRECT STAFF AND THE ATTORNEY GENERAL'S OFFICE TO TAKE ALL OTHER ACTIONS NECESSARY TO CARRY OUT THE FOREGOING, INCLUDING ACTION TO COMPEL THE LESSEE TO QUITCLAIM OIL AND GAS LEASE NOS. PRC 4000.1 AND PRC 7911.1 TO THE STATE.

B: IN THE ALTERNATIVE, IF CARONE CAN DEMONSTRATE TO THE COMMISSION'S SATISFACTION AT THE JUNE 1, 2009 MEETING THAT:

- (1) THE CVA'S REPORT RECOMMENDING RE-QUALIFICATION OF PLATFORM HOGAN HAS BEEN, OR WILL BE SUBMITTED IN A TIMELY MANNER, TO THE MMS, AND
- (2) CARONE HAS RESUBMITTED AN APPLICATION FOR AN RUE TO THE MMS THAT INCLUDES APPROPRIATE RESPONSES TO ALL OF THE DEFICIENCIES NOTED IN THE FEBRUARY 2008 LETTER SENT TO CARONE BY THE MMS, AND
- (3) CARONE HAS FULLY EXECUTED AND FUNDED THE COMMISSION'S REIMBURSEMENT AGREEMENT, THEN THE STAFF RECOMMENDS THAT THE COMMISSION:
 1. DIRECT STAFF TO FOLLOW UP TO ENSURE THAT THE PLATFORM IS RE-QUALIFIED BY THE MMS AND THAT THE APPLICATION FOR AN RUE IS DEEMED COMPLETE BY THE MMS AND TO REPORT BACK TO THE COMMISSION SHOULD THERE BE ANY FURTHER DELAY IN MOVING THE PROJECT FORWARD.

EXHIBIT B

PRC 7911.1
PRC 4000.1

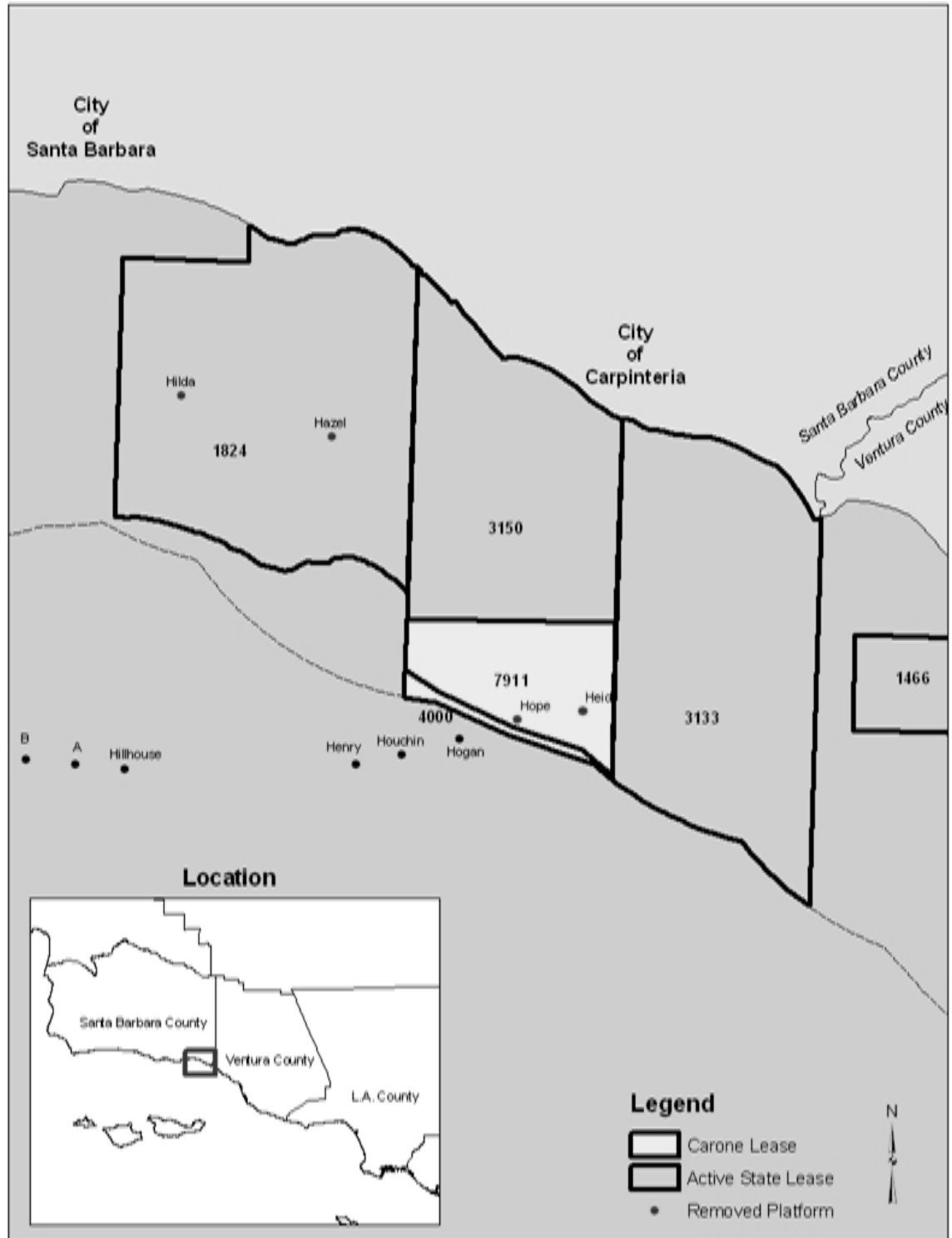
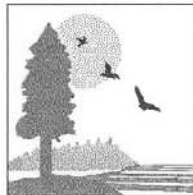


EXHIBIT C

STATE OF CALIFORNIA

ARNOLD SCHWARZENEGGER, *Governor*

CALIFORNIA STATE LANDS COMMISSION
200 Oceangate, 12th Floor
Long Beach, CA 90802-4331



PAUL D. THAYER, *Executive Officer*
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from Voice Phone 1-800-735-2929

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September 30, 2008

File Ref: PRC 7911
PRC 4000
W 40813

Mr. Steve Coombs
Carone Petroleum, Inc.
1145 Eugenia Place, Suite 200
Carpinteria, CA 93013

RE: Project Application for PRC 7911/4000 Development from OCS Platform Hogan

Dear Mr. Coombs:

Almost twelve years ago, on October 28, 1996, the California State Lands Commission approved the assignments to Carone Petroleum, Inc. of State Oil and Gas Lease PRC 4000 and a portion of State Oil and Gas Lease PRC 3150. The Commission renumbered the portion of Lease PRC 3150 assigned to Carone as PRC 7911. As a result of the Commission's action, the Commission and Carone entered into an agreement documenting the Commission's approval of the assignments and setting forth the conditions to the assignments to which Carone agreed. In paragraph 8 of that agreement, Carone agreed to submit to the Commission within two years of the effective date of the assignments a plan for the development of both leases and to begin drilling operations on both leases within three years of the effective date of the assignments. None of this happened. Twelve years have passed and little has transpired that would give the Commission's staff confidence that any of it ever will.

The leases must be produced commercially if they are to be retained by Carone. They cannot be continued in effect indefinitely with no commercial production or with no diligent action by Carone to attempt to achieve commercial production. The staff, therefore, is setting a deadline for Carone's performance of certain actions that are essential steps in the completion of the necessary prerequisites to achieving commercial production. These prerequisites are completion of the environmental review of the development project under CEQA, structural requalification by the Minerals Management Service of Platform Hogan and approval by the MMS of a plan for drilling into the State leases from Platform Hogan.

First, Carone shall execute and fully fund in the amount of \$650,000 no later than December 15, 2008, a new reimbursable agreement in order to resume and complete the CEQA process. This is asking for no more than what Carone committed to do in

2004, but then failed to do. Due to the passage of time, the CEQA work previously done is stale and the contract for the consultant that will prepare the EIR may have to be rebid.

Second, Carone shall begin immediately and proceed diligently with the process for obtaining the structural requalification of Platform Hogan. Carone shall provide to the staff on or before December 15, 2008, a fully executed contract with a staff-approved structural integrity contractor. The contract shall include a date certain that is no later than April 1, 2009, for the commencement of the work to be undertaken by the contractor and a schedule for completion of that work with a target date for completion.

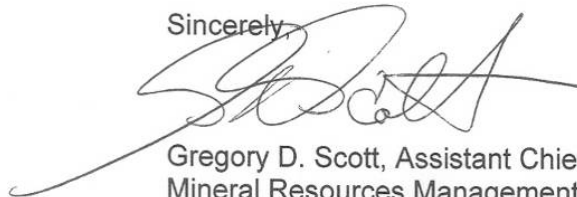
Third, Carone shall provide the MMS no later than December 15, 2008, with a detailed written proposal for expeditiously proceeding with and concluding the process for obtaining the approval of the MMS of a plan for drilling from Platform Hogan into Carone's State leases. The proposal shall include a time schedule and a commitment by Carone to keep the staff fully and timely informed of all aspects of this federal approval process.

If Carone is unable or unwilling to comply with any of the three demands (the reimbursable agreement for CEQA, the contract with the structural integrity contractor or the letter to the MMS initiating the approval process) by their December 15, 2008 due dates, then Carone shall submit to the Commission a quitclaim of both Lease PRC 4000 and Lease PRC 7911. If Carone fails to supply any of materials by their due dates and then fails to quitclaim both leases, the staff will bring before the Commission its recommendation that the Commission find that Carone is in default under both leases, including the conditions of their assignment to Carone, and take all appropriate action to terminate both leases.

In addition, the staff is seeking Carone's assent to enter into discussions about Carone providing the State with compensation for past and present drainage of State hydrocarbon resources by wells drilled by Carone into federal lands near the federal/state boundary. The drainage from these wells on federal lands continues to occur, and has been prolonged as a result of Carone's dilatory approach in pursuing the development of the State.

Please contact me by October 15, 2008, to let me know your decision on the appropriate path for Carone. Please also contact me if you have any questions, or wish to discuss the contents of this letter.

Sincerely,



Gregory D. Scott, Assistant Chief
Mineral Resources Management Division

Cc: Paul D. Thayer, Executive Officer

EXHIBIT D

PRC 7911.1
PRC 4000.1

**CARONE PETROLEUM CORPORATION
1145 EUGENIA PLACE, SUITE 200
CARPINTERIA, CA 93013**

January 20, 2009

Mr. Gregory D. Scott, Assistant Chief
Mineral Resources Management Division
California State Lands Commission
200 Oceangate, 12th Floor
Long Beach, CA 90802-4331

RE: PRC 7911/4000 Development from OCS Platform Hogan

Dear Mr. Scott:

This letter is in response to your September 30, 2008 letter regarding the status of the permitting activity related to the subject development. As a result of two recent follow-up meetings that we have had with you and your staff, we have developed a response that we believe represents our recent discussions, as well as accommodates certain national and world-wide developments that have occurred since those discussions.

We understand from our meetings that a re-start of the environmental impact /CEQA process will most likely entail a re-bid of the work to qualified EIR vendors. We understand the State's current estimate for this work is \$325,000. We also understand that the current estimate for the State's budget to review future work and submittals (both from Carone and others) is approximately \$325,000 for a total combined budget of \$650,000.

During our November 4, 2008 meeting with you and other CSLC staff Carone Petroleum made it clear that they were currently pursuing a financing process that would raise the capital required to fully fund this project. We made certain representation and project commitments to you as a result. At that time, however, the price of crude oil was trading at approximately \$65 / bbl. Unfortunately, since then the price has dropped another \$20 - 25 / bbl., with some "experts" predicting further declines soon to come. This additional drop in price along with the ongoing turmoil in the financial markets and the dramatic downturn in the overall economy has resulted in our lenders advising the company that the financing process must be put on hold until their own situations stabilize and world oil price again achieves some measure of predictability.

Our situation is not unique. As you are fully aware, most of the country's huge institutions, such as Citibank, as well large insurance companies and the Detroit automakers are all reeling from the downturn and are all receiving bailout assistance from the Federal government. Similar help is also being sought by entire economic sectors, such as housing and the several states, including California. That bailout process is now being played out in agonizing detail before all our eyes on the evening news. Accordingly, in view of these extraordinary circumstances (all of which are beyond our ability to control), we have no choice but to ask you for a "bailout" as well, in the form of additional time to allow the

markets to stabilize. We do not know how long that will take, although we shall be pleased to provide you with monthly reports of our own loan negotiation status. Our hope here is to do whatever we can to demonstrate how important these California State lease reserves are to us, as well as to our prospective lenders. Because of that importance, you may be assured that we are leaving no stone unturned to conclude successful financing negotiations at the earliest possible moment. Once that is accomplished, you will have no reason to fear that our efforts to expedite full development of those reserves will be dilatory; the oversight of our lenders will effectively prevent that.

Accordingly, as discussed during our November 4, 2008 in your office, Carone Petroleum has agreed to the following:

- 1) Once monthly average NYMEX crude oil price reaches \$60/bbl for a minimum of three consecutive months, we agree to enter into a new reimbursable agreement in the amount of \$650,000. Funding of this agreement will require an initial deposit of \$50,000 at time of execution and the balance due when the company completes its financing process.
- 2) Carone will continue its efforts to complete a seismic requalification of platform Hogan. A large amount of progress has been made on this effort and we expect to have a design brief submitted in January, 2009 and final results submitted within the first quarter of 2009.
- 3) As part of the EIR / CEQA process, Carone will submit an updated State Lease Development Plan to CSLC for their approval in the first quarter of 2009. This will provide a basis for transferring new and updated project information to the EIR / CEQA vendor.
- 4) Carone Petroleum has submitted a right of use and easement application to the Minerals Management Service to develop the State Lease reserves from federal water platform Hogan. The MMS has responded to the initial submittal with a request for additional information and clarification. Carone will complete the RUE application and resubmit in the first quarter of 2009.

We believe that this summarizes our agreement to the discussion points raised during our recent meeting at your offices and invite any additional thoughts you may have on this subject. In conclusion, we wish to take this opportunity to reiterate our strong desire to accomplish all those things necessary to allow us to commence our redevelopment of the properties under your jurisdiction as soon as practicable. Thank you for your courtesy and cooperation to date.

Very truly yours,

CARONE PETROLEUM CORPORATION

By:



Charles W. Cappel,
President

EXHIBIT E

PRC 7911.1
PRC 4000.1

STATE OF CALIFORNIA

ARNOLD SCHWARZENEGGER, *Governor*

CALIFORNIA STATE LANDS COMMISSION

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February 5, 2009

File Ref: PRC 7911

PRC 4000

W 40813

Mr. Charles W. Cappel, President
Carone Petroleum, Inc.
1145 Eugenia Place, Suite 200
Carpinteria, CA 93013

RE: PRC 7911/4000 Development from OCS Platform Hogan

Dear Mr. Coombs:

Staff of the California State Lands Commission (State) has received and considered Carone's January 20, 2009 response to the State's September 2008 letter as well as to the discussions between Carone and Staff since then. In these discussions, Staff attempted to work with Carone to help Carone fulfill the terms of lease assignments, but never consented to placing an indefinite hold on its requests that Carone move forward. Carone's recent response, however, places an indefinite hold on Carone's compliance with all Staff requests that would require Carone to spend money. The inability of Carone to spend money on operations to develop the leases raises an even more fundamental question, which is the capacity of Carone to continue to hold the leases.

Staff requested that Carone commit to the development of the leases by (1) executing a new reimbursable agreement for CEQA and submitting an initial deposit for the CEQA work, (2) executing a contract with a structural integrity contractor for the remaining analysis of Platform Hogan and (3) initiating the process for making a complete application with the Minerals Management Service for a Right of Use and Easement. Staff said that if Carone were unable or unwilling to do so, then Carone shall submit to the Commission by December 15, 2008, quitclaims for both lease PRC 4000 and lease PRC 7911. In its response, Carone states that until the NYMEX crude oil price is at least \$60 per barrel for three consecutive months it is not financially able to comply with all of Staff's requests for committing to the pursuit of this project and intimates that it has no intention of quitclaiming the leases.

Mr. Charles W. Cappel
Carone Petroleum, Inc.
RE: PRC 7911/4000 Development from OCS Platform Hogan
February 5, 2009
Page 2

As Staff said in the September 2008 letter, it would bring to the Commission its recommendation that Carone is in default under both leases if Carone had not complied with Staff's three requests for moving the project forward or had not quitclaimed the leases. Staff appreciates the current economic climate and the problems with securing credit. However, Staff believes that Carone's current economic problems do not mitigate twelve years of delay. What little Carone promises in its January 20, 2009 letter does not involve monetary expenditures necessary to provide Staff with a full project application and causes Staff great concern about the financial ability of Carone to continue to hold these leases. Carone's stated intent to put off all actions appears to be dependent upon oil prices stabilizing at or above \$60 per barrel, something that is extremely difficult to predict. If oil prices continue to be volatile as they have been in the recent past, then the State has no assurance that Carone ever will be financially capable of carrying out its long-term obligations under the leases.

Staff, therefore, will recommend to the Commission that it find Carone in default under both lease PRC 4000 and lease PRC 7911. If the Commission finds Carone in default, Carone will have 90 days to cure the default. Complying fully with Staff's requests outlined in its September 2008 letter would cure the default. This includes fully funding the reimbursable agreement for CEQA and Staff processing in the amount of \$650,000. You may of course also file quitclaims, making Staff's recommendation to the Commission for default unnecessary. Because the Commission's approval of the lease assignments to Carone in 1996 was conditioned upon Carone's submission of a plan for development within two years and the commencement of drilling within three years, Staff's recommendation of default twelve years later does not appear to be precipitous.

Sincerely,



Gregory D. Scott, Assistant Chief
Mineral Resources Management Division

cc: Honorable John Garamendi
Lt. Governor
State of California
State Capitol, Room 1114
Sacramento, CA 95814

Honorable John Chiang
State Controller
300 Capitol Mall, Suite 1850
Sacramento, CA 95814

Mr. Charles W. Cappel
Carone Petroleum, Inc.
RE: PRC 7911/4000 Development from OCS Platform Hogan
February 5, 2009
Page 3

Honorable Michael C. Genest
Director, Department of Finance
State Capitol, Room 1145
Sacramento, CA 95814

Paul Thayer, Executive Officer
California State Lands Commission
100 Howe Avenue, Suite 100-South
Sacramento, CA 95825

EXHIBIT F

CALENDAR ITEM

41

A 35

PRC 7911.1

PRC 4000.1

M. Voskanian

S 18

J. Planck

**CONSIDER FINDING CARONE PETROLEUM CORPORATION
IN DEFAULT OF SUBSURFACE (NO SURFACE USE)
OIL AND GAS LEASE NOS. PRC 7911.1 AND PRC 4000.1,
OFFSHORE CARPINTERIA,
SANTA BARBARA COUNTY**

LESSEE:

Carone Petroleum Corporation
Attn.: Mr. Charles W. Cappel, President
1145 Eugenia Place, Suite 200
Carpinteria, CA 93013

AREA, LAND TYPE, AND LOCATION:

Oil and Gas Lease No. PRC 7911.1 contains approximately 1,541 acres of submerged land, which originally comprised the southern portion of Oil and Gas Lease No. PRC 3150.1, and Oil and Gas Lease No. 4000.1 contains approximately 204 acres of submerged land. Both are offshore Carpinteria, Santa Barbara County, California.

BACKGROUND:

Background – Lease Acquisitions, Conditions and the Development Plan

Oil and Gas Lease No. PRC 3150.1, consisting of approximately 5,553 acres offshore and south of the city of Carpinteria, was originally leased to Standard Oil Company of California (later Chevron) and Richfield Oil Corporation (later ARCO) in July 1964. The lessees installed two platforms (Hope and Heidi) on the leased lands, and drilling and production operations continued from 1966 until 1992. Between 1992 and 1996, Hope and Heidi and two other platforms on an adjacent lease were removed. ARCO and Chevron assigned the southern portion of lease No. PRC 3150.1, containing approximately 1,541 acres, to Carone Petroleum Corporation (Carone). That assignment was approved by the Commission on October 28, 1996. The assigned lease was re-designated Oil and Gas Lease No. PRC 7911.1, is limited to subsurface (no surface use) operations by Carone, and is to be accessed and developed from Platform Hogan which Carone

CALENDAR ITEM NO. 41 (CONT'D)

operates in federal waters on the Outer Continental Shelf. The assignment was intended to further the best interests of the State by preventing drainage of oil and gas resources beneath these lands from Carone's operations on adjacent federal lands. The Commission later approved an assignment of the balance of Oil and Gas Lease No. PRC 3150.1 to Venoco for potential development by Venoco from its onshore facilities of a near shore geologic structure just offshore and under the city of Carpinteria.

Oil and Gas Lease No. PRC 4000.1, consisting of approximately 204 acres of submerged land lying between the southern boundary of Oil and Gas Lease No. PRC 3150.1 and the offshore 3-mile federal/state boundary, was issued to Standard Oil Company of California (later Chevron) and Atlantic Richfield Company (later ARCO) in August 1968. The Commission also approved the assignment of Lease No. PRC 4000.1, in its entirety, to Carone at the same October 28, 1996 meeting when it created Oil and Gas Lease No. PRC 7911.1 from the southern portion of Oil and Gas Lease No. PRC 3150.1 and approved its assignment to Carone.

In addition to lease requirements obligating Carone to exercise reasonable diligence in the development of these leases, the assignment of Oil and Gas Lease Nos. PRC 4000.1 and PRC 7911.1 was subject to an agreement between Carone and the State imposing various conditions upon the Commission's approval of the assignment. Among those conditions is one that required that Carone "submit to the Commission within two years of the effective date of the assignments of the leases [by November 1, 1998] a plan for the development of both leases" and "begin drilling operations on both leases within three years of the effective date of the assignments of the leases [by November 1, 1999]."

After several extensions of these deadlines, Carone submitted to staff a development plan application on October 25, 1999. On November 23, 1999, staff responded with a letter finding the application incomplete. Upon continued urging by staff to provide the materials needed to complete the application, Carone provided some but not all of the requested materials on or about October 23, 2000. That response was supplemented with more materials on October 24, November 3, and November 21, 2000. On December 11, 2000, staff responded with a second incomplete letter stating that Carone had still failed to provide a complete application. Carone finally provided all materials required to make the application complete on or about January 14, 2001.

The EIR Process

Under the California Environmental Quality Act (CEQA, see Public Resources Code sections 2100 et seq.), the Commission cannot approve the development plan proposed in Carone's application until all the necessary environmental

CALENDAR ITEM NO. 41 (CONT'D)

documents have been prepared. As such, completion of the CEQA process is a necessary precondition that Carone must satisfy prior to any operations occurring that would restore production of oil or gas to the leased lands and under the lease terms, Carone must exercise reasonable diligence in completing the CEQA process in order to avoid termination of the lease (Lease Paragraph 1. "... Lessee shall commence and thereafter prosecute with reasonable diligence ... other operations which shall result in the restoration of production of oil and gas from leased lands."). The Commission is the lead agency under CEQA and is the primary agency responsible for ensuring the proper completion of the CEQA process.

Staff deemed the application for the proposed development plan complete on February 28, 2001, pending the receipt from Carone of a signed reimbursement agreement covering the costs of preparing the EIR for the development project as required by statute (PRC § 21089). The notice of preparation (NOP) for the EIR was issued on June 6, 2001. The scoping meeting, bid review, and interviews of the prospective consultants occurred between June 6 and July 31, 2001. After the consultant was selected, work began on the EIR on March 27, 2002.

On October 29, 2002, work on the EIR was suspended for 180 days in order to perform and analyze results of an American Petroleum Institute (API) level 3 structural survey that was needed to determine if any major work was required to strengthen Platform Hogan, the platform in federal waters from which the development of the state leases would occur, and if such work were required, whether this work had to be considered in the EIR. An additional extension of 120 days was requested by Carone and approved by staff because the analysis of the survey was not yet available. The analysis of the survey showed that although some maintenance and repair work was required, no major modifications of the platform would be needed so that there would be no construction requiring consideration in the EIR. However, left unresolved was the seismic analysis required by the State (to a 1000 year event) using new site specific standards. When the MMS determined that a structural requalification of Platform Hogan would be required, the parties agreed to finish the seismic analysis through that process.

Upon expiration of the suspension, staff contacted Carone to resume work on the EIR. Carone requested further suspension of work on the EIR on June 10, 2003 and October 24, 2003 in order to finish the expensive maintenance and repair work required by the API survey on its two federal platforms, Platform Hogan and Platform Houchin.

CALENDAR ITEM NO. 41 (CONT'D)

In February of 2004, after continued requests by staff, Carone reaffirmed its commitment to the development project and represented unequivocally that it would authorize resumption of work on the EIR no later than May 1, 2004, and if it failed to do so, it would quitclaim the leases. On May 1, 2004, Carone directed staff to resume work on the EIR. An Administrative Draft of the EIR was completed for staff review in January 2005.

The federal review process, requiring, among other matters, an expanded structural analysis of Platform Hogan (see below) and finalization of the seismic analysis, caused further delays and requests from Carone for suspension of the EIR process. Ultimately, Carone did not seek resumption of the work on the EIR and the EIR contract with the State's consultant expired in January 2008. As of March 2009, eight years have passed since the EIR process was started and four years have passed since the process stalled at the Administrative Draft phase. Carone has not taken the necessary steps to resume the EIR process.

The Federal Process

In order for the Mineral Management Service (MMS) to approve Carone's proposal to drill into its State leases from Platform Hogan, MMS regulations require that Carone revise its field Development and Production Plan (DPP) or submit an application for a Right of Use and Easement (RUE). In June 2005, MMS reported to the staff, in response to staff's inquiry, that a revision to the Carpinteria Field DPP was the appropriate way for Carone to proceed and that Carone had not applied for such a revision.

A revision to the DPP would also require that the platform from which the drilling would occur be "requalified" structurally to show that it can accommodate the drilling and production operations over their estimated life. The State also requires that any new project from a platform analyze the structure's ability to withstand a 1000 year seismic event. At a January 2007 meeting with staff, and also in a follow up letter to staff, Carone stated that it had not yet made application for a revised DPP, but would do so within 30 to 45 days. In April 2007 in response to a staff request, the MMS informed staff that Carone still had not made an application for a revised DPP or a RUE to obtain authorization to use Platform Hogan. In July 2007, Carone sent staff another letter stating that it was still planning to submit a revised DPP. The MMS informed staff, in January 2008, that Carone had submitted an application for a RUE. In February 2008, the MMS sent a letter to Carone regarding deficiencies in its application (equivalent to a staff "incomplete" letter) and requested more information from Carone. As of March 2009, Carone had still not corrected the application deficiencies identified by the MMS staff, nor had it submitted any additional information or otherwise responded to the MMS request. The MMS also determined that a structural requalification of Platform Hogan would be required and has informed staff that it

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has not yet received a response from Carone regarding the requalification of Platform Hogan (which became part of staff's demands discussed below). Carone has informed staff that it has requalified its other nearby federal platform, Platform Houchin, and claims that it should take a very short time to requalify Platform Hogan because of its similarities with Platform Houchin. Based on its information from Carone, staff believes that the requalification of Platform Hogan has not been accomplished because of Carone's inability to obtain financing.

At this time, three and a half years after staff's first inquiry regarding Carone's securing MMS approval for using Platform Hogan to drill into and produce its state leases, seven years after requests for a complete structural integrity analysis of the platform, eight years after initiation of processing of its completed application for Commission approval of the project, and almost thirteen years after the Commission conditionally approved the assignment, Carone has failed to secure both the required approvals from the MMS and the required structural requalification of Platform Hogan.

Recent Staff Demands that Carone has Failed to Complete

On September 30, 2008, staff wrote to Carone requesting three actions from Carone, all of which Carone would be capable of doing without the approval of other governmental agencies. Compliance would require Carone to make a financial commitment to diligently pursue the development project for State Oil and Gas Lease Nos. PRC 4000.1 and PRC 7911.1. (This letter is attached as Exhibit C.) Staff set deadlines for the completion of each of these three actions. First, staff asked Carone for a fully executed and fully funded agreement for the resumption and completion of the CEQA process. The amount to be funded would be \$650,000, and it would be due by December 15, 2008. Second, staff asked Carone to submit by December 15, 2008, a fully executed contract with a structural integrity contractor for the structural requalification of Platform Hogan, and requiring the contractor to commence work by April 1, 2009. Third, staff requested that Carone provide to the MMS by December 15, 2008, a detailed written proposal for expeditiously proceeding with and concluding the process for obtaining MMS approval for Carone to drill into and produce the state leases from Platform Hogan. Staff also included a demand that Carone submit quitclaims for both Lease PRC 4000.1 and PRC 7911.1 if it failed to complete all three requests.

Carone did not comply with any of the actions set forth in the September 30 letter from staff. Instead, Carone provided its response in a letter to staff dated January 20, 2009. (This letter from Carone is attached as Exhibit D.) The basic premise of Carone's response was that it did not have the financial resources to pursue this project at this time and could make no financial commitments to the project until the monthly average NYMEX crude oil price is at least \$60 per barrel

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for at least three consecutive months. In other words, Carone has put the project on an indefinite hold. Carone also said that by the end of the first quarter of 2009, it anticipated final results on the requalification of Platform Hogan would be available, and it would submit to the staff a revised development plan and complete and submit a RUE application to the MMS. Staff is not aware of any progress having been made on completing any of these matters, none of which, even if completed, demonstrates a financial commitment by Carone to use reasonable diligence to pursue the development project intended to return these leases to production.

Staff responded to Carone in a letter dated February 5, 2009. (A copy of this letter is attached as Exhibit E.) In that letter, staff reiterated the statement in its letter of September 30, 2008, including that it would bring to the Commission a recommendation of finding Carone in default if it failed to comply with the required actions set forth in that letter or failed to file quitclaims for the two leases. Noting the severity of the current economic conditions and particularly the tightening of the credit market, staff, nonetheless, stated that these conditions do not mitigate twelve years of delay since Carone acquired the leases. If Carone's stated intent is to delay pursuit of project development until oil prices stabilize at or above \$60 per barrel, then the State has no assurance that Carone ever will be capable of carrying out its long-term obligations under the lease.

Staff, therefore, is recommending that the Commission find Carone in default of both Leases PRC 4000.1 and PRC 7911.1. Under the default provision of the leases (Lease Paragraph 6) the lease may be forfeited upon the failure of the lessee after 90 days written notice and demand to comply with any of the lease provisions. Paragraph 1 of both leases requires the lessee to "pursue diligently" drilling and other well operations that would restore production so that the lease would not terminate due to the absence of commercial production. Staff has worked with Carone for over twelve years to restore production on these leases. When the Commission approved the assignment of the leases to Carone in 1996, it conditioned its approval on Carone providing a development plan in two years and to begin drilling in three years, a condition to which Carone agreed. Twelve years have passed, and Carone has not met these conditions. During these twelve years, oil prices have been high and credit has been available, giving Carone ample opportunity to pursue and complete the required lease development. Waiting until oil prices stabilize at or above \$60 per barrel means waiting for an indefinite time to do what Carone could and should have done during the past twelve years. The assignment was approved to protect state resources from drainage and secure additional production from the lands. Since the approval of the assignment, there is still no production of the leased lands and Carone's operations on adjacent federal lands may still be draining state resources.

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The staff's recommendation of default is based specifically on Carone's failure to comply fully with the three actions demanded in the staff's September 30, 2008 letter to Carone, that were to demonstrate Carone's reasonable diligence in restoring production of oil and gas from these leased lands, as required in paragraph 1 of the leases. Pursuant to the lease terms, Carone has 90 days from a notice of default to cure the matters upon which the default is based. If the Commission were to find Carone in default, Carone would have 90 days to comply fully with all three requests or to file quitclaims for both leases. If these leases are quitclaimed, the leased lands will be placed in the coastal sanctuary as required by the California Coastal Sanctuary Act of 1994.

STATUTORY AND OTHER REFERENCES:

Public Resources Code Sections 6827 and 6829 and Lease Paragraphs 1 and 6

OTHER PERTINENT INFORMATION:

1. Pursuant to the Commission's delegation of authority and the State CEQA Guidelines [Title 14, California Code of Regulations, section 15060(c)(3)], the staff has determined that this activity is not subject to the provisions of the CEQA because it is not a "project" as defined by the CEQA and the State CEQA Guidelines.

Authority: Public Resources Code section 21065 and Title 14, California Code of Regulations, sections 15060 (c)(3) and 15378

2. This activity involves lands identified as possessing significant environmental values pursuant to Public Resources Code sections 6370, et seq., but such activity will not affect those significant lands.

Authority: Public Resources Code sections 6370 et seq.

EXHIBITS:

- A1. Land Description – PRC 7911.1
- A2. Land Description – PRC 4000.1
- B. Location Map
- C. Staff's September 2008 Letter
- D. Carone's January 2009 response to Staff's Letter
- E. Staff's February 2009 Letter

PERMIT STREAMLINING ACT DEADLINE:

N/A

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RECOMMENDED ACTION:

IT IS RECOMMENDED THAT THE COMMISSION:

CEQA FINDING:

1. 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) BECAUSE THE ACTIVITY IS NOT A PROJECT AS DEFINED BY PUBLIC RESOURCES CODE SECTION 21065 AND TITLE 14, CALIFORNIA CODE OF REGULATIONS, SECTION 15378.
2. FIND THAT THIS ACTIVITY IS CONSISTENT WITH THE USE CLASSIFICATION DESIGNATED BY THE COMMISSION FOR THE LAND PURSUANT TO PUBLIC RESOURCES CODE SECTIONS 6370, ET SEQ.

AUTHORIZATION:

1. FIND CARONE PETROLEUM CORPORATION, AS LESSEE, IN DEFAULT UNDER THE OBLIGATIONS OF OIL AND GAS LEASE NOS. PRC 4000.1 AND PRC 7911.1, FOR FAILURE TO PURSUE WITH DILIGENCE THE DEVELOPMENT OF THOSE LEASES
2. DIRECT STAFF TO ISSUE A DEFAULT NOTICE THAT WILL PROVIDE THAT IF THE DEFAULT IS NOT CURED BY FULLY COMPLYING WITH THE THREE DEMANDS SET FORTH IN THE STAFF LETTER OF SEPTEMBER 30, 2008, WITHIN NINETY (90) DAYS OF THE DEFAULT NOTICE, THE LEASES SHALL BE FORFEITED AND CANCELED.
3. DIRECT STAFF AND THE ATTORNEY GENERAL'S OFFICE TO TAKE ALL OTHER ACTIONS NECESSARY TO CARRY OUT THE FOREGOING, INCLUDING ACTION TO COMPEL THE LESSEE TO QUITCLAIM OIL AND GAS LEASE NOS. PRC 4000.1 AND PRC 7911.1 TO THE STATE.