

**STAFF REPORT
C71**

A 37

11/29/2017
PRC 1466.1
PRC 410.1
PRC 145.1
S. Blackmon
J. Fabel

S 19

**CONSIDER THE FUTURE DISPOSITION OF STATE OIL AND GAS LEASE NOS.
PRC 1466.1, PRC 410.1, AND PRC 145.1, HELD BY RINCON ISLAND LIMITED
PARTNERSHIP AND THE SUITABILITY OF PROPOSALS SUBMITTED ON BEHALF
OF THE BANKRUPTCY ESTATE OF RINCON ISLAND LIMITED PARTNERSHIP
FOR ALTERNATE OPERATORS TO ASSUME CONTROL OF THOSE LEASES.**

LESSEE:

Rincon Island Limited Partnership

INTRODUCTION:

In November 2014, regulatory violations were discovered on RILP's largest lease PRC 1466.1, (Rincon Island) that Commission staff believe posed, and continue to pose, a threat to public health and safety and the environment. Since that time, Commission staff have expended great effort to force the lessee, Rincon Island Limited Partnership (RILP) to fix and make Rincon Island safe from the unreasonable threat it posed to public health and the environment from an uncontrolled release of oil. Staff's goal in this endeavor, was to have the island secured from the potential harms it posed and to ensure the island never again posed such risk.

In mid-November 2017, after exhausting all reasonable options to address Commission staff's concerns short of lease termination, at the direction of the Commission, staff requested that RILP, through the appointed chapter 11 bankruptcy trustee, voluntarily release its rights and interests in State oil & gas leases PRC 1466.1, PRC 145.1, and PRC 410.1, so that the leases will terminate. RILP has consented and, as a result, over 1,500 acres of Sovereign Public Trust Lands will soon be added to the California Coastal Sanctuary and the last offshore oil production facility in Santa Barbara state waters will close. Once the leases terminate, Commission staff will commence the process of securing the leases and planning for the future plugging and abandonment of the numerous oil and gas wells across the leases.

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BACKGROUND:

What follows is a summary of events preceding October 2017. For a detailed discussion of the leases, their operational and regulatory history, and the bankruptcy proceedings in the matter of *in re: Rincon Island Limited Partnership*, please see the informational staff report ([Item 77, August 17, 2017](#)).

RILP's leases consist of leases PRC 145.1 and 410.1 (Shoreside Leases) originally executed in 1944 and 1949, respectively, and lease PRC 1466.1 (Rincon Island)(collectively, the Leases), executed in 1955. The Shoreside Leases have been developed by means of wells directionally drilled from onshore sites primarily located on private property landward of U.S. Highway 101. Rincon Island is an artificial island constructed in 1959 for the purposes of well drilling and oil and gas production. Rincon Island is located approximately 3,000 feet offshore in water 55 feet deep and is connected to the shore by a causeway. RILP has been the operator of the Leases since 1995.

In November 2014, during a routine inspection of Rincon Island and its facilities, staff discovered that at least two wells were capable of natural flow (meaning oil capable of flow without mechanical assistance). The pressure in these wells raised substantial concerns among staff engineers that a wellhead failure on one of these wells could result in an uncontrolled flow of oil at the surface. Between November 2014 and August 2016, staff, in conjunction with the Department of Conservation's Division of Oil, Gas, and Geothermal Resources (DOGGR), identified and ordered RILP to address numerous additional regulatory and lease violations culminating in an April 2016 notice of default and, after the notice went unaddressed, a staff recommendation to terminate the Leases at the Commission's August 9, 2016, meeting. On August 8, 2016, RILP declared chapter 11 bankruptcy in Dallas, Texas, shielding the leases from termination.

At the Commission's direction, staff vigorously contested RILP's bankruptcy proceedings to either force RILP to resolve the persistent safety concerns on the Leases or to have the case dismissed so that the Commission could act upon the Leases, up to and including their termination. In June 2017, the Commission asked the court to lift the bankruptcy protections over the Leases. The court granted the Commission's request in part by appointing a chapter 11 trustee to oversee RILP's organization and by establishing a deadline of October 30, 2017, for the trustee to either confirm a plan to successfully reorganize RILP's business or to find a new operator to take over the Leases. Failure to meet these deadlines, without an extension from the Commission, would cause the bankruptcy protections over the Leases to lift. In July 2017, the trustee hired DrilTek, Inc., an oil operations contractor based in Bakersfield, to oversee day-to-day operations on the Leases and another firm to market the Leases.

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STAFF ANALYSIS AND RECOMMENDATION:

Authority:

California Public Resources Code sections 6804.1 and 6829.

The Trustee's Marketing of the Leases Failed to Find a New Lessee Acceptable to Commission staff:

The bankruptcy code provides the court and trustee wide authority to transfer the Leases—if such a transfer is in the best interest of RILP's estate. Commission staff did not object to the lease sales process, believing that it was the last opportunity to find a responsible, prudent operator to permanently address the safety concerns on Rincon Island and avoid abandonment liability to the State; however, Commission staff did reserve all rights to object to any transfer that involved an inexperienced, undercapitalized, or imprudent operator.

On September 25, 2017, the trustee asked the Commission to extend the court's October 30 deadline to sell the Leases to November 30, 2017. The request was based on the impact of Hurricane Harvey on the marketing firm hired by the trustee (located in Houston, Texas) to conduct its work along with firms, some based in Houston, to generate bids to buy the Leases by October 30. Commission staff granted the extension as a measure of good faith.

In total, five firms placed bids for the Leases and only one was deemed acceptable to UBS AG bank, RILP's largest secured creditor. On October 23, 2017, Commission staff received a proposal to operate the Leases by West Energy Offshore, Ltd. (WEO). Commission staff and WEO met in the Commission's Long Beach office on October 31, 2017, to discuss a revised proposal by WEO. After the meeting, WEO indicated it would submit another revised proposal. By letter dated November 2, 2017, Commission staff asked WEO to submit vital financial information including WEO's current assets, holdings, and income generated; identification of any other entities or person that sought to be a co-lessee or have an interest in the Leases; information regarding the financial strength or capitalization of WEO, such as letters of credit or evidence of capital commitments; and detailed information on the nature and extent of any proposed carve-outs (liability reduction) WEO believed would be necessary to make operation of the Leases economical.

By November 9, 2017, after reviewing the submitted proposals and evaluating the financial characteristics of WEO, staff determined that, while WEO had the wherewithal to likely address the immediate regulatory violations on Rincon Island, WEO's corporate structure and lack of assets

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gave little confidence that it could weather a financial downturn without quickly falling into bankruptcy and causing the State to again litigate over the Leases. On November 14, 2017, the Commission staff delivered a letter to the trustee indicating that WEO did not meet the Commission's standards as a potential lessee for Rincon Island and that staff would object to any sale of the Leases (letter attached as Exhibit B). Consequently, Commission staff, by direction of the Commissioners, requested that the trustee grant a quitclaim deed releasing all rights and interests in the Leases.

Because No Further Alternative Exists to Permanently Resolve Safety Concerns on Rincon Island, Commission Staff Requested that RILP Voluntarily Surrender its Interests, Effectively Terminating the Leases:

At the Commission's direction, staff requested that the trustee voluntarily surrender RILP's interest in the leases back to the State. On November 15, 2017, Commission staff, the trustee, and UBS AG bank agreed to file a joint motion with the court to authorize the filing of a quitclaim deed by the trustee, effectively terminating the Leases (Joint Motion). Staff believes a quitclaim deed is the most efficient method for terminating the Leases because once voluntarily filed, it is immediate and not subject to contest. It also allows the Commission to immediately enter the properties and commence any safety procedures. Commission staff expect the court to hear the Joint Motion on or around November 29, 2017.

Pursuant to California Public Resources Code section 6804.1, the trustee, on RILP's behalf, may file with the Commission a written quitclaim or relinquishment of all rights under a lease. The quitclaim is effective upon filing with no action by the Commission needed. Importantly, filing a quitclaim deed does not release RILP from its obligations to abandon and decommission the existing oil and gas facilities, nor is RILP relieved from liability stemming from a breach of the lease at the time of the quitclaim. As further discussed below, although RILP's abandonment obligations will persist after filing a quitclaim deed, because RILP is essentially insolvent, responsibility to secure the lease facilities, perform plugging and abandonment of the wells, and decommission the facilities will likely fall to the State.

Commission Staff Recommends That the Commission Additionally Authorize Termination of the Leases:

Both the trustee and UBS AG Bank have joined the Commission in good faith to file the Joint Motion; however, under the court's current orders, the bankruptcy protections over the leases will lift November 30, 2017, regardless, allowing the Commission to terminate those Leases starting

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December 1, 2017. In the event that the Joint Motion is not granted, staff recommends that the Commission grant the Executive Officer the authority to terminate the Leases at her discretion, after November 30. This authority is intended to provide Commission staff with the flexibility to enter and secure the Leases in the event securing a quitclaim deed becomes unreasonably delayed or made impossible.

Firm grounds to terminate the Leases exists. Many of the Lease defaults identified in the Commission's April 11, 2016, default notice remain unabated. On Rincon Island, there are still four wells on which casing or tubing pressure cannot be read. More importantly, only 20 of the 48 wellheads on the island have working master valves, and nine of these will require extensive work to replace the valve. Master valves are the primary means of manually shutting in a well at the surface, and are also necessary to pump fluids into, or bleed fluids from, the casing and tubing strings. Thirty-nine well heads require repair to accommodate a blowout preventer device. In addition, Rincon Island has not produced oil or gas in commercial quantities in nearly a decade. A failure to produce, as required under the lease, is a basis for termination. Finally, RILP has failed to maintain a good and sufficient bond on any of the Leases. RILP's current bond of \$9.65 million is \$730,000 short of the minimum bond amount of \$10.38 million required by the Leases. The insufficient bond is a violation of the Rincon Island and Shoreside Leases and grounds for termination.

Effects of Termination:

Under the California Coastal Sanctuary Act of 1994, once the Leases are terminated, the lands currently under lease (approximately 1,500 acres) will become part of the California Coastal Sanctuary. (Pub. Resources Code, § 6242) Future oil and gas extraction will not be permitted unless authorized by the legislature.

Upon termination, RILP will be relieved of many obligations under the Leases including production and development obligations; however, RILP's obligation to properly abandon the Leases and remove its improvements persists. Upon termination of the Leases, RILP must commence the process of safely securing the premises and planning for the abandonment of the Lease facilities. Based on RILP's conduct and filings in its bankruptcy proceedings, RILP is essentially insolvent meaning that it will be unable to perform its post-termination obligations.

On November 12, 2017, Commission staff were notified by the trustee that ongoing funding for the current operator on Rincon Island, DrilTek Inc., (DrilTek) would cease in response to staff's objection to WEO being a new

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lessee. On November 15, 2017, staff executed an emergency contract with DrilTek to remain on the Leases. DrilTek will maintain 24-hour monitoring, maintenance, pressure reduction operations, and permit and inspection compliance. Commission staff anticipates soliciting bids for a contract to conduct permanent well plug and abandonment in the first quarter of 2018 with actual work to occur at some point in mid-late 2018. After well plug and abandonment is complete the final disposition of the Island and connecting causeway will be considered by the Commission, subject to public comment and compliance with the California Environmental Quality Act (CEQA).

Because RILP is likely insolvent, the responsibility for abandonment and decommissioning obligations will fall to the State. The Commission holds a \$9.65 million bond guarantying the faithful performance of RILP's lease obligations. Commission staff have commenced the process of tendering this bond and are cooperating with the surety, AIG, to apply those funds towards future abandonment. In addition, the Commission holds \$8 million in settlement funds from ARCO related to ARCO's residual liability on Rincon Island from prior operations. Details of the ARCO settlement can be found in a previous informational report ([Item 77, August 17, 2017](#)). In total, the Commission retains a total of \$17.65 million in cash and guaranties to offset abandonment liability costs on the Leases. Additionally, staff are seeking to preserve potential claims against other prior operators to further offset costs.

Public Trust and State's Best Interests Analysis:

The proposed termination of the Leases, by quitclaim or by direct action of the Commission, is consistent with the common law Public Trust Doctrine because the purpose is to prevent environmental harm that may result from an uncontrolled discharge of oil from the Leases and commit those lands to the California Coastal Sanctuary. A discharge, or even an unreasonable threat of a discharge, due to poor maintenance and operation of the Leases, would significantly interfere with the public's right to the use of Public Trust lands for the purposes to which they are uniquely suited. In addition, such a discharge would negatively impact Public Trust resources. In administering its Public Trust responsibilities, the Commission may exercise its discretionary authority to accommodate the changing needs of the public. Additionally, it is in the State's interest to enforce the terms of the leases it enters into, particularly those terms that are designed to protect the State and its resources and assets. Therefore, given the potential issues related to the operation of these Leases, in their current condition, coupled with the addition of approximately 1,500 acres of sovereign land being added to the Coastal Sanctuary, the

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Commission's action to terminate the Leases is consistent with the common law Public Trust Doctrine and in the State's best interests.

OTHER PERTINENT INFORMATION:

1. Authorizing the termination of the Leases is not a project as defined by CEQA because it is an administrative action that will not result in direct or indirect physical changes to the environment.

Authority: Public Resources Code section 21065 and California Code of Regulations, title 14, section 15378, subdivision (b)(5).

2. This proposed termination of the Leases is consistent with Strategy 1.5 of the Commission's Strategic Plan to ensure the highest level of environmental protection and public safety in the production and transportation of oil and gas resources.

EXHIBITS:

- A. Location Map
- B. Letter dated November 14, 2017, to the chapter 11 trustee

RECOMMENDED ACTION:

It is recommended that the Commission:

PUBLIC TRUST AND STATE'S BEST INTERESTS:

Find that the proposed termination will not substantially interfere with the Public Trust needs and values at this location at this time, is consistent with the common law Public Trust Doctrine, and is in the State's best interests.

AUTHORIZATION:

1. Find that RILP is in violation of, and has failed to make sufficient good faith efforts to cure the operational and facility deficiencies described in Commission staff's April 11, 2016 default notice, which include violations of the explicit provisions of the Leases to operate in a proper workmanlike manner and violations the California Code of Regulations. RILP's failure to cure the operational and facility deficiencies amount to a default of its obligations under lease PRC 1466.1.
2. Find that RILP has failed to make sufficient good faith efforts to cure the deficiency in its performance bond as identified in Commission staff's April 11, 2016 default notice and confirmed by the bankruptcy court. The failure to maintain a sufficient blanket

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performance bond in the amount of \$10.38 million as provided in the Leases amounts to a default of its obligations under leases PRC 1466.1, PRC 145.1, and PRC 410.1.

3. Delegate authority to the Executive Officer, or her designee, to terminate leases PRC 1466.1, PRC 145.1, and PRC 410.1 at the Executive Officer's discretion and to serve notice or execute any instruments necessary to effectuate the termination of the Leases.
4. Authorize the Executive Officer or her designee to enter upon the leased land to secure the oil production and storage facilities in order to prevent harm to human health or the environment.
5. Order RILP, upon filing of a quitclaim deed or termination by the Executive Officer, to commence its obligations to fully abandon all existing wells and facilities located within the Leases and restore those lands to their natural state.
6. Authorize the Executive Officer or her designee to solicit proposals, negotiate a fair and reasonable price, award and execute contracts for plugging and abandonment of the oil and gas wells on the Leases.
7. Authorize the Executive Officer or her designee, in cooperation with the Office of the Attorney General, to take all steps reasonably necessary, including litigation, to enforce the termination of leases PRC 1466.1, 145.1, and PRC 410.1 against RILP and any agents, affiliates, successors, or assigns; to access the Leases to ensure the health and safety of the people of California and the surrounding environment; to eject trespassers that occupy the Leases; to remove improvements from State sovereign land overlaying the Leases; to restore the sovereign land at this location to the satisfaction of the Commission; and to recover the Commission's damages and costs.

EXHIBIT A

PRC 145.1
PRC 410.1
PRC 1466.1



EXHIBIT A
PRCs 145.1, 410.1, 1466.1
Rincon Island Limited Partnership
Leases
VENTURA COUNTY



This Exhibit is solely for purposes of generally defining the lease premises, is based on unverified information provided by the Lessee or other parties and is not intended to be, nor shall it be construed as, a waiver or limitation of any State interest in the subject or any other property.

Exhibit B

STATE OF CALIFORNIA

EDMUND G. BROWN JR., Governor

**CALIFORNIA STATE
LANDS COMMISSION**



Established in 1938

EXECUTIVE OFFICE
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November 14, 2017

File Ref: PRC 1466.1
PRC 410.1
PRC 145.1

Jason Searcy
Searcy & Searcy
446 Forest Square
Longview, TX 75605

Subject: *In re: Rincon Island Limited Partnership*, N. Dist. of Texas,
No. 16-33174

Dear Mr. Searcy:

This letter is to inform you, as the Chapter 11 Trustee appointed in the matter of *In re: Rincon Island Limited Partnership*, that, after reviewing proposals submitted by West Energy Offshore Ltd. (West) to operate state oil and gas leases PRC 1466.1, PRC 410.1, and PRC 145.1 (the Leases), staff of the California State Lands Commission cannot agree that West has the financial and operational abilities and resources to address the ongoing threats adequately and permanently that the Leases pose to public safety and the environment. Furthermore, to date, no other potential operator has presented a viable plan for acquiring and complying with the terms and conditions of the Leases. Consequently, Commission staff must object to the transfer of the Leases to West. The only viable option remaining for Commission staff is to enter and secure the Leases either through termination by the Commission following expiration of the court ordered stay or, to avoid unnecessary expenditures of time and resources, through a voluntary release, remise, and quitclaim by Rincon Island Limited Partnership.

Since July 2017, your office has worked under the authority of the bankruptcy court to market the Leases for sale. While Commission staff did not object to the process and has since cooperated with the court and your office, the Commission reserved all rights to object to a sale if all defaults were not timely cured. Commission staff further indicated that, even if an operator could be found to resolve the Commission's outstanding issues sufficient to produce a mutually agreeable lease amendment, the Commission would still object to an operator that is insufficiently capitalized, lacks experience operating offshore California, or reflects a history of imprudent operations. The purpose of these threshold requirements is to ensure that the Leases, if transferred by the Trustee, would be held by a responsible and fiscally sound operator that could adequately and permanently address the continuing regulatory violations and abandonment and oil spill liabilities associated with these Sovereign

Exhibit B

Jason Searcy
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Public Trust lands. If the Leases are not transferred, then, once the automatic stay lifts, Commission staff intends to seek lease termination and secure the facilities to ensure public and environmental safety.

To this end, Commission staff has worked in good faith to allow your office to conduct an open and fair sales process. Staff consented, without objection, to the hiring of a facility operator and a second firm to market the Leases; provided all requested public records to your office; made technical and legal staff available to answer questions; and, on September 26, 2017, agreed to your office's request for a one-month extension of the court ordered deadline to lift the automatic stay. In addition, Commission staff kept open communication with West, meeting three times by phone prior to West's first proposal submission on October 23, 2017.

Commission staff and West also met in person at the Commission's Long Beach office to discuss West's return to production proposal on October 31, 2017. As a result of the conversation, and questions and concerns of staff, West indicated it would revise its proposal and resubmit.

As outlined in Commission staff's November 2, 2017, letter to West, staff required that West provide information addressing nine discrete issues before a future lease amendment could be negotiated. Foremost among these requests was the revised proposal addressing concerns voiced by Commission staff and clarifications regarding West's financial fitness to operate the Leases. The information requested included West's current assets, holdings, and income generated; identification of any other entities or person that seek to be lessees or have an interest in the Leases; information regarding the financial strength or capitalization of West, such as letters of credit or evidence of capital commitments; and detailed information on the nature and extent of any proposed carve-outs (liability reduction) West believes would be necessary to make operation of the Leases economical.

To date, Commission staff has not received the requested materials. As such, a lack of clarity continues to exist regarding West's status as a legal entity capable of holding the Leases, West's assets or property, and West's proposed corporate structure and parental associations. Commission staff is also very concerned that West plans to finance all initial lease operations and capital with third-party debt based on production levels that appear to Commission technical staff to be inflated, creating a very real potential that West's proposal is not economically feasible. These elements impact Commission staff's confidence in West's financial fitness to operate the Leases. As such, Commission staff are not inclined to wait and see what type of organization that West will develop to operate the Leases or to assess West's financial capabilities only after the Leases are transferred. Furthermore, Commission staff's significant concerns about decommissioning liabilities remain unresolved because West does not have sufficient capital either to meet more traditional bonding requirements or to establish or develop a satisfactory sinking fund.

Exhibit B

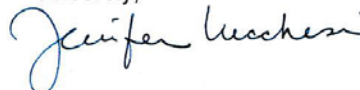
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Additionally, although the individual members of West have offshore oil field experience, West, as an organization, has no past record of regulatory compliance or operations. West has offered its principal's connection with Pacific Energy Resources Ltd. (PER) as an example of prior offshore experience. While PER did operate federal platforms in the Beta unit offshore Huntington Beach and Alaska, winning safety awards from the Minerals Management Service, PER operated for only three years before filing for Chapter 11 bankruptcy and ultimately seeking liquidation. More troubling is that the liquidation caused PER to abandon its Alaska state lands lease for Platform Osprey, which led Alaska to litigate to prevent the public from having to pay the decommissioning costs. Although staff understands that West's principals left PER shortly before that event occurred, the outcome is the exact event Commission staff seeks to avoid if and when consent were to be granted for a new operator.

Taken together, West's proposal requires that the State of California continue to carry a significant degree of liability with very little positive benefit accruing to the State. While West's team currently includes substantial talent and experience, it has little proven ability to withstand any financial setbacks or operational contingency if events do work against its plans. Commission staff's goal is to secure the Leases to ensure public and environmental safety and to assure that the Leases never again pose such a risk. Staff has concluded that, to protect the State's environment and resources, the only way to ensure such a result, based on the two options before the Commission, is for the Leases to end and for the State to commence abandonment and decommissioning activities itself. Accordingly, Commission staff, pursuant to its duties under the Public Trust to safeguard California's sovereign lands, must object to a proposed sale of the Leases to West and will recommend termination. Commission staff therefore requests that your office voluntary release, remise, and quitclaim Rincon Island Limited Partnership's interest in the Leases to the State.

Commission staff appreciates the work that West, your office, UBS AG, and other parties have invested in the sales process. If you have any questions, please feel free to contact the Commission's staff Attorney, Joseph Fabel, at (916) 574-0964 or at joseph.fabel@slc.ca.gov.

Sincerely,



JENNIFER LUCCHESI
Executive Officer