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Tranquillon Ridge Offshore Oil and Gas Lease Agreement

L E G I S L A T I V E   A N A L Y S T ' S   O F F I C E

Presented to:

Senate Budget and Fiscal Review Committee

Hon. Denise Moreno Ducheny, Chair

LAO

65 YEARS OF SERVICE

Summary of Governor's Tranquillon Ridge Offshore Oil and Gas Lease Proposal

☑ ***Assumes Approval of Lease by Either State Lands Commission (SLC) or Legislature.*** The budget assumes quick approval/authorization of the Tranquillon Ridge oil and gas lease in the current fiscal year, so as to generate, for use beginning in 2009-10, an upfront payment of $100 million from the lessee once permits are acquired. It is estimated that over the next 14 years the Tranquillon Ridge lease will generate $1.8 billion in revenues for the state.

☑ ***Proposed Use of Funds.*** The administration proposes using $79 million of the upfront payment to go directly to the benefit of the General Fund in the current year, with the remaining $21 million to be used in the budget year to restore General Fund program cuts made previously in the Department of Parks and Recreation (DPR). Another estimated $119 million in lease revenues will be received in the budget year. The administration has proposed using this amount to supplant a like amount of General Fund support in DPR. For future years, the administration plans to use the lease revenues to "fund state parks."

Key Issues Raised by Proposal

☑ ***Policy Issues Related to Approving Lease.*** Three primary policy issues concerning the approval of the Tranquillon Ridge lease agreement have been raised:

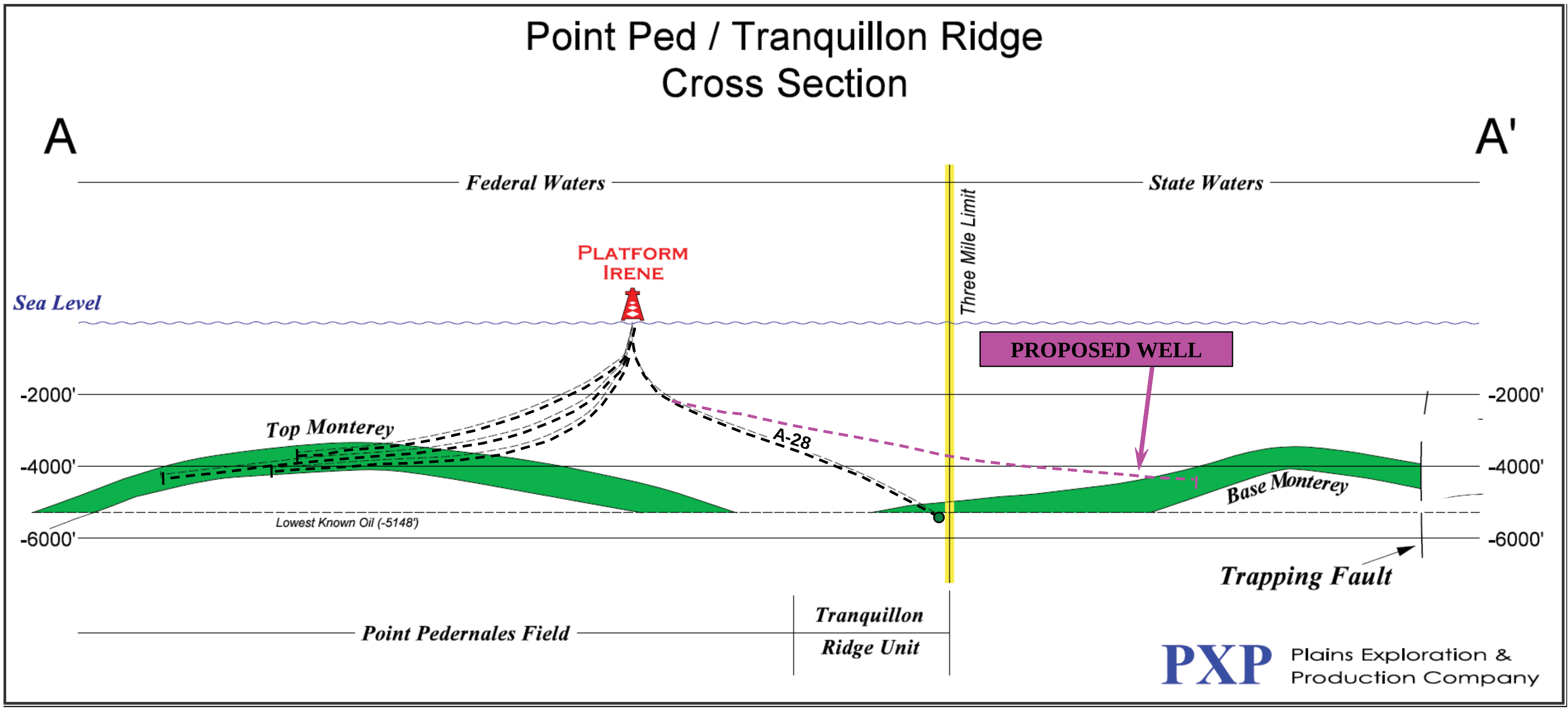
- The risk of oil spills.
- Potential precedent set that may be seen as supporting increased drilling in federal waters.
- Potential unenforceability of certain environmental concession provisions in the lease agreement and in a "side agreement" between the lessee and an environmental organization.

☑ ***Reasonableness of Budget's Revenue Assumptions.*** Uncertainty exists as to the administration's assumptions about the timing of the receipt of revenues and the amount of potential revenues under the lease.

Project Description

- ☑ Plains Exploration and Production Company (PXP) has applied for an offshore oil and gas lease covering the Tranquillon Ridge Oil Field which is located in state waters directly offshore from the Santa Barbara County coast.

- ☑ The PXP plans to use their existing platform, Platform Irene, which is located in federal waters to slant drill 14 wells from the existing structure into state lands in order to access and recover an estimated 40 million to 90 million barrels of oil over a 14-year period.



New Offshore Oil Drilling: Current Law and Practice

☑ ***Offshore Oil Drilling: State Law and Practice.*** Since the 1969 Santa Barbara oil spill, California has enunciated a policy of choosing protection of coastal resources over new offshore oil leases. Over the years, the Legislature has added prohibitions against new leasing in additional offshore areas. In 1994, with the passage of the California Coastal Sanctuary Act, the Legislature enacted a de facto prohibition on all new leases in state coastal waters but provided limited exemptions from this policy. The SLC has not approved a new lease since 1968, and since 2001 has adopted numerous resolutions opposing new leases in federal waters.

☑ ***The SLC-Commissioned Independent Study Found Tranquillon Ridge Meets Physical "Drainage" Exemption Requirement That Allows for New Offshore Oil Lease.*** The California Coastal Sanctuary Act contains an exception that allows for drilling "if the Commission (SLC) determines that those oil or gas deposits are being drained by means of producing wells upon adjacent federal lands and the lease is in the best interests of the state." In the case of Tranquillon Ridge, drainage of state resources by a well located in federal waters is occurring via production from Federal Well A-28.

Policy Issues

- ☑ ***Oil Spill Risk.*** Increasing the volume of oil production increases the probability of an oil spill. The Environmental Impact Report (EIR) which was prepared by Santa Barbara County found that, assuming a 14-year oil production termination date, the probability of an oil spill from oil production associated with Platform Irene increases from a current 5.4 percent to 11 percent under the Tranquillon Ridge proposal. According to the EIR, the potential worse-case oil spill size is estimated to be 7,929 barrels. In comparison, the 1969 Santa Barbara oil spill, which has been attributed to a wellhead blowout, was estimated to be approximately 80,000 to 100,000 barrels. Since the Santa Barbara spill, aspects of oil spill risk have declined due both to technological advancements that increase the safety of oil production and newly established oil spill prevention regulatory programs.

- ☑ ***Precedent-Setting Concern.*** The SLC often cites the state's record of not approving new state leases in state waters as support for opposition to new leases in federal waters. Some believe that approval of this lease will change the debate in California and Washington D.C. from whether additional leases should occur to the circumstances under which they should be approved.

- ☑ ***Enforceability of Third-Party Agreement.*** A Santa Barbara environmental group (Environmental Defense Center) entered into agreement with PXP over the project that attempts to enforce a termination date of oil production in both state and federal waters near Tranquillon Ridge. Both SLC staff and the state Attorney General, however, question the enforceability of any termination date. At issue is whether the U.S. Minerals Management Services (MMS) will give its required "sign off" to a proposed termination date.

Revenue Issues

☑ ***Administration's Projected Revenues for Current and Budget Years Overly Optimistic.*** The Governor's budget assumes that an advanced royalty payment of $100 million would be paid to the state in 2009-10 with $119 million in full-year royalty revenues in 2010-11. This assumes a March 2010 project approval date. However, we think that it is more reasonable to assume a project approval date several months later. This means that the advanced royalty payment is unlikely to be collected until the budget year. In addition, the time from which drilling commences until the time that newly drilled wells begin to produce oil could be several months. This lag time means that the budget's assumption for a full year of royalty revenues in the budget year is also overly optimistic.

☑ ***Revenue Projections for Future Years Are Inherently Uncertain.*** Given that future oil prices are inherently difficult to predict due to their volatility, so too is it difficult to predict potential revenues from the Tranquillon Ridge lease, especially beyond 2010-11. As production quantities are driven by the price of oil, it is also difficult to predict the amount the producer is willing to pump in any given year, a factor which determines the amount of royalty revenues. The budget assumes that over the 14-year production period, Tranquillon Ridge will generate $1.8 billion for the General Fund. However, given the above considerations, this revenue projection is highly uncertain.

LAO Recommendations

- ☑ ***Evaluate Proposal to Approve Tranquillon Ridge Project Based on Merits, Rather Than as an Opportunity to Provide a Funding Source for State Parks.*** The administration has proposed "funding state parks" through revenues generated from Tranquillon Ridge. In evaluating the merits of the proposal, however, particular focus should be placed on the policy choices associated with the project. If the Legislature decides to approve the project, it will want to maintain flexibility in the potential use of revenues received from Tranquillon Ridge.

- ☑ ***On Balance, Proposal to Approve Tranquillon Ridge Project Merits Legislative Approval.*** There are policy and fiscal trade-offs that need to be weighed in considering the Tranquillon Ridge proposal. The proposal is consistent with current statutory policy which provides an exception to the general ban on any new offshore oil and gas leases if it is found that resources are being drained from adjacent federal facilities. On the other hand, a certain amount of risk is inherent with the proposed activity. While the Legislature will want to evaluate the proposal accounting for the policy concerns that have been raised, it should weigh these concerns against the opportunity to gain much-needed revenues for the General Fund. Analyzing the potential risks and trade-offs, we find, on balance, that the Tranquillon Ridge proposal merits legislative approval.