THE PORT OF LOS ANGELES

AUDIT COMMITTEE

Report to the
Board of Harbor Commissioners

Item #2

"FOR INFORMATION ONLY"

DATE: APRIL 18, 2013

TO: AUDIT COMMITTEE OF THE BOARD OF HARBOR COMMISSIONERS
DOUGLAS KRAUSE, CHAIR
SUNG WON SOHN, Ph.D., MEMBER

FROM: PLANNING & ECONOMIC DEVELOPMENT

SUBJECT: REPORT ON THE STATUS OF FAULT BLOCK II OIL ROYALTIES

SUMMARY:

At the Board of Harbor Commissioners (Board) meeting of November 15, 2012, Commissioner Krause requested staff to further research the issue of possible royalties due to the Port of Los Angeles (Port) by Mobil Oil (Mobil) from the Port's mineral interests in Fault Block II (FB II) within the Wilmington Oil Field. The Port's consultant CGE OIL, LLC (consultant) prepared an analysis of the events and accounting of FB II (Transmittal 1).

The Port owns a 0.46 percent mineral rights interest in FB II (Transmittal 2), the majority of which is owned by the City of Long Beach and operated by Tidelands OPC (Tidelands). Order 2583, a drilling and operating contract created in 1956, established Mobil as a Working Interest Owner (WIO) responsible for paying a share of the proceeds of certain wells in FB II to the Port as a Royalty Interest Owner (RIO). In 1989, the owners of the FB II unit voted to continue a steamflood operation to ameliorate subsidence and increase oil production in the unit. Mobil did not consent to the steamflood, meaning that Mobil would not pay any costs or receive any revenues from the operation until the unit recovered two hundred fifty percent of the investment costs and one hundred percent of the operating costs of the steamflood. It is not clear whether Mobil required the Port's consent to take this action. Payments from Mobil to the Port ceased at this time.

Once the steamflood operation took effect, the FB II unit divided the operator's accounting between the pre-existing waterflood and steamflood operations with Mobil and the Port remaining in the waterflood. Because Tidelands does not have a full and accurate record of the accounting of the steamflood operation, the consultant recreated that accounting using actual data where available and estimates where necessary. The

accounting revealed that the payback for the two hundred fifty percent of investment costs for the steamflood has not been recovered, which means that Mobil has not received any revenues and does not owe the Port royalties from the steamflood operations. Mobil also does not owe the Port royalties on the waterflood operation, as Order 2583 is no longer in force and, while it was in force, its royalties were based on production from wells that are all currently abandoned. The consultant prepared an accounting of a hypothetical situation in which the Port's royalties were calculated for its 0.46 percent interest in all field production in Parcels 1 and 4 of FB II, instead of just from the now-abandoned wells listed in Order 2583. Hypothetical royalty rates were set at either 35 percent as per Order 2583 or 16 percent as per comparable current agreements. Even in that hypothetical situation, the royalties due to the Port would be minimal; the total estimated Port royalty amount for the last four years would be less than $84,000 at a 16 percent royalty or $177,000 at a 35 percent royalty (Figure 1 of Transmittal 1).

Options for the Future of Fault Block II

The Port has two options to choose from with regards to its future participation in FB II – it can become a WIO or a RIO. The decision to become a WIO or a RIO for the Port is based mostly on the financial implications. A WIO ultimately has liability for any expenses, including abandonment costs at the end of field life. Historically, the Port has leased its rights to a WIO and assumed a RIO position under the WIO thereby, in theory, eliminating any current or future liability and ensuring a near constant cash flow. However, because the Port's ownership in FB II is considered State Tidelands, the Port cannot quit claim or relieve itself from liabilities, thereby making the option to remain a RIO less beneficial financially.

In the short term, a WIO pays its allocated monthly expenses from the oil field and receives its allocated revenues. Tidelands has in practice not expensed the smaller WIOs in the field but has (as was in the case with Mobil) netted those WIOs and carried a negative balance at times when expenses exceed revenues. Although Mobil has neither accepted a payment from Tidelands nor paid the Port a royalty since 1989, they have a slight positive balance in their account (Figure 2 of Transmittal 1) as a WIO. Mobil's balance to date is approximately $27,000. Tidelands has invested a substantial amount of capital into FB II's operations over the past year in order to increase oil production. It is anticipated that revenues will significantly exceed expenses going forward, making this an ideal time for the Port to become a WIO in FB II. A realistic estimate of potential revenue to the Port is $10,000 a month, based on current oil prices and production amounts.

In discussions with the consultant, the City of Long Beach has agreed in concept to remove Mobil as a WIO in FB II at the Port's formal written request, with the Port becoming a WIO in Mobil's place. The City of Long Beach would also discontinue the separation of the waterflood and steamflood accounting and allow the Port to be a part of the FB II waterflood on a go forward basis without a negative balance. The Port could request that the City of Long Beach establish an abandonment fund on the Port's behalf for future liability and deduct a portion of the proceeds due the Port to eventually fully fund the liability. The Port could also establish its own abandonment liability fund or choose to not establish one with the knowledge that it may be responsible for its share of abandonment costs at the end of the field life. If at any time the Port wished to revert to a RIO status, the Port could seek a new WIO through a Request for Proposals process, which would require Board approval and approval through the State Lands Commission.

TRANSMITTALS:

1. CGEOIL LLC Report on Fault Block II Ownership
2. Map of Wilmington Oil Field Fault Blocks