

CALIFORNIA OIL AND GAS LAW

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INTRODUCTION

California has a well-deserved reputation for stringent environmental regulation and for policy initiatives encouraging development of renewable energy resources. It is therefore worth reminding residents and non-residents alike that the Golden State is also one of the world's great oil provinces.

The largest oilfields in the state (such as Midway-Sunset in the San Joaquin Valley) have been in production for well over a century, thanks to steamflooding and other enhanced recovery techniques suitable for the heavy and viscous California crude. A single well, the 1910 'Lakeview Gusher', alone unleashed 8 million barrels, and the economic base of 1920s Los Angeles and Long Beach was founded on the oil derricks that lined the shore. But the 1969 Dos Cuadras blowout in federal waters offshore Santa Barbara led to a moratorium and a reversal of opportunities for expansion of production in frontier locations.

With proven conventional resource reserves of about 3 billion barrels, California stands behind only Texas, Alaska and now North Dakota among US states. Liquids production statewide fell between 1985 and the present to about 200 million barrels per year or 550,000 barrels per day, as offshore output declined and onshore activity was subject to greater restrictions.

Reserve estimates for unconventional resources, especially those embedded in shale formations, have swung widely in response to perceived changes in existing technology and economics. As many as 15.5 billion barrels were earlier deemed recoverable from the Monterey formations in central California. But the U.S. Energy Information Administration officially recognized in May 2014 an estimate of only 600 million barrels of that enormous quantity. This downgrade has no impact on current production, which

is estimated to increase from 14,000 barrels per day up to 57,000 barrels per day.

As with the rest of the United States, government policy towards upstream oil and gas in California is at best ambivalent. Production enjoys the benefit of clear private and public leasing regimes, depletion allowances, and a number of nearby refineries. Foreign investment in California production has been accepted alongside domestic investment. But some of the most promising fields are located in urban areas where land use and environmental challenges are among the most intense in the country, and the state's greenhouse gas (GHG) programme (exemplified by Assembly Bill 32 of 2006 (AB 32)) will make local consumption more costly relative to alternative sources of hydrocarbons.

Clearly the greatest pending issue for California oil and gas is the debate over the terms under which hydraulic fracturing takes place. While efforts to impose a statewide moratorium failed, some counties and cities have passed or are considering local moratoria or restrictions. The principal recent state law, Senate Bill 4 (SB 4), requires a comprehensive independent study of the impacts of hydraulic fracturing and acid well stimulation treatments conducted in California; completion of an environmental impact report; promulgation of new regulations governing well construction and other technical aspects of hydraulic fracturing and acid well stimulation; and development of a new permit programme designed to provide extensive information to the public about the source of water and chemicals used in the process and groundwater monitoring. The full weight of SB 4 will not come into effect until 2015, when new regulations are implemented. Whether these studies, or other political forces, will lead to additional substantive restrictions on—or incentives for—shale oil and other unconventional production in California remains to be seen.

LEGAL AND REGULATORY FRAMEWORK

Domestic oil and gas legislation

Preliminarily, it is important to note that California follows general United States legal principles with respect to oil and gas resources. The right to explore for and produce hydrocarbons is generally associated with the owner of the possessory surface interest in land, unless that right has been severed through grant, reservation or lease.

Federal laws such as the Mineral Leasing Act and the Outer Continental Shelf Lands Act (OCSLA) apply to production on federal land or in federal waters, while the California Public Resources Code and related codes and regulations govern production on state land or in state waters. The Civil Code governs private development and allocation of production rights and activities, as supplemented in significant ways by federal, state and local health, safety and environmental laws.

Regulation

The principal agency is the California Department of Conservation and in particular its Division of Oil, Gas and Geothermal Resources (DOGGR). It issues permits for development, rework and abandonment of wells and has adopted regulations applicable to production more generally, including regulations applicable to underground injection activities. Important roles in regulating or permitting particular upstream activities are also played by the state air, water and waste agencies within the California Environmental Protection Agency (CalEPA), the regional water quality boards, air pollution control districts, coastal and bay development regulators, and counties and municipalities. For federal property, agencies within the US Department of Interior exercise similar roles: the Bureau of Land Management (BLM) for onshore properties and the Bureau of Ocean Energy Management (BOEM) for offshore properties. The DOGGR and BLM have entered into a memorandum of understanding for coordination of their respective oversight activities on federally owned land in California administered by the BLM.

Treaties

Treaties are not a major factor in California production or US production more generally, although the New York Convention facilitates enforcement of arbitral awards and the US is a party to many bilateral and multilateral tax, trade and investment treaties. The 1978 protocol to the 1973 International Convention for the Prevention of Pollution from Ships (MARPOL) spurred the US Oil Pollution Act of 1990, which applies to coastal facilities not limited to vessels. The US is not a party to the Law of the Sea Treaty, although

it considers some of the treaty's provisions to be declaratory of customary international law.

LICENSING

California does not have a general programme of production sharing contracts or concessions. Instead, the right to conduct exploration and production is obtained through individual oil and gas leases awarded by the state (typically through the State Lands Commission (SLC)) or negotiated with a private landowner or landowners. Where the oil producer holds a fee interest in the land (i.e., where the estate is not split between the surface owner and a mineral rights owner), production may proceed without a lease.

Pursuant to OCSLA and in accordance with a five-year plan, the BOEM grants offshore oil leases on the California outer continental shelf to the highest qualified responsible bidder on the basis of sealed competitive bids. Auctions are based not on variable royalty rates but rather on the 'signature bonus' offered.

Pursuant to the Mineral Leasing Act, the BLM has responsibility for oil leasing on federal lands onshore California, as well as state and private surface lands in California where mineral rights have been retained by the federal government. Lands cannot be leased until they are first offered competitively at an auction, which is conducted by oral bidding; no sealed or mailed bids are accepted. Leases are awarded to the highest qualified responsible bidder. Lands that have been offered competitively and received no bids are then made available non-competitively for leasing for two years.

On privately held California lands, any person or entity capable of legally contracting with the lessor can do so, subject to state regulatory requirements. A typical oil and gas lease grants the right to explore for hydrocarbons and the ownership of oil and gas actually produced. These leases typically feature an initial term of three to five years, during which a rental is paid, subject to extension for force majeure, and then the leasehold continues for so long as oil and gas are produced in paying quantities. The royalties vary with the location and risk but often are in the range of one-sixth or three-sixteenths of the well head value, subject to certain deductions. The leases are not ordinarily subject to revocation absent default by the lessee.

PRODUCTION RESTRICTIONS

California, like other US states, reserves the right to regulate production in the form of 'conservation programs'

(California Public Resources Code, Section 3450). The US Department of Commerce restricts exports of all domestically produced crude oil by requiring a licence for such export. Except for a few categories of transactions that are exempted or have a presumption of approval by the Bureau of Industry and Security (BIS), the BIS reviews licence applications on a case-by-case basis.

There are no general requirements that production be sold in local California markets. The antitrust laws are the principal restraints on the private posting of prices at which crude oil is purchased in California, although from time to time there have been calls for price regulation of refined products in particular states and channels of distribution.

ASSIGNMENTS OF INTERESTS

The transfer process differs for federal, California state, and private land interests. Assignments of interests in federal production require BOEM approval for offshore property and BLM approval for onshore property. The SLC approves transfers of interests in California state oil and gas leases under Section 6804 of the Public Resources Code. In both cases, the new operator must furnish bonding or other acceptable security. Transfers of interest in private production, on the other hand, frequently require consent of the surface owner or other parties with an interest in the production; such arrangements frequently involve pre-emptive rights or potentially payments or additional security.

The DOGGR further regulates the transfer of interests in California wells, requiring a report of property/well transfer and appropriate bonding for the transferee's activities. Generally these approvals are reviewed from the standpoint of compliance with law and adequate assurance of creditworthiness, and do not entail a commercial right of first refusal or adjustments to commercial terms.

TAX

In California as elsewhere in the US, the income tax regime for exploration and production has numerous special features. A host of industry-specific deductions apply to upstream expenditures—including pre-drilling exploration costs, intangible drilling costs, accelerated depreciation of oilfield equipment and most notably the depletion of subsurface resources. Tax planning is required for optimal acquisition and divestiture of leases and other production interests, such as production payments and farm-ins. California state income tax has similar features. A California severance tax on production of oil and gas has been proposed on several occasions, the latest in February 2014.

ENVIRONMENTAL IMPACT AND DECOMMISSIONING

A new or modified exploration or development operation will usually need a local land use development permit as well as drilling and operating permits. In California, an operator will always require a new or reworked drilling permit from the DOGGR, and depending on local ordinances may also need a local conditional use permit from the applicable county or municipality. In a few California counties, drilling operations may be conducted as of right, obviating the need for a local land use permit.

Many projects must undergo a thorough environmental impact review under the federal National Environmental Policy Act (NEPA) or the California analogue, the California Environmental Quality Act (CEQA). Both the NEPA and CEQA reviews include substantial public involvement, can be quite contentious and can delay projects. The process for a CEQA review of hydraulic fracturing and acid well stimulation is now defined by the complex new requirements of state legislation, SB 4. Failure to complete the process or comply with permits can lead to significant delays, penalties and injunctions.

Discharge restrictions

The federal laws applicable to the discharge of pollutants into the environment are generally not industry-specific. They are instead based on a particular impact: the Resource Conservation and Recovery Act (RCRA) regulates the management of solid and hazardous waste; the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA or Superfund) governs the clean-up of contaminated sites; the Clean Air Act (CAA) regulates air emissions from mobile and stationary sources; and the Clean Water Act (CWA) and Safe Drinking Water Act (SDWA) protect surface water and underground sources of drinking water. The principal federal enforcement agency is the Environmental Protection Agency (EPA), but the CalEPA and regional agencies enforce similar state laws and can also be delegated authority by the EPA to implement and enforce certain federal statutes such as the CAA, the CWA and RCRA.

California state and regional agencies have additional regulatory authority under state law; for example, the Porter-Cologne Water Quality Control Act protects all California groundwater, which is not covered by the CWA or SDWA. Some of these laws contain exemptions applicable to petroleum and exploration and production wastes, but the patchwork of laws and regulations is sufficiently complex that virtually all discharges are regulated in some manner.

While the foregoing environmental laws are applicable throughout the economy, there are some authorities that are focused on the oil and gas sector. For example, under the CWA, the EPA has issued effluent guidelines specific to upstream oil operations, as well as rules applicable to the discharge of oil into navigable waters. The Oil Pollution Act of 1990 (OPA) addresses clean-up and damage assessments relating to oil spills into the navigable waters of the US, the adjoining shorelines, or the exclusive economic zone. By way of contrast, California and other state regulatory agencies protect ‘state waters’, which are usually intrastate bodies of water and groundwater. Virtually all oil and gas facilities are subject to the requirements of the CWA if located in proximity to waters of the US, including tributaries, ephemeral streams and wetlands. The CWA generally protects the waters of the US from sources of pollution by prohibiting the discharge of pollutants, including storm water associated with industrial activities, without a permit. The CWA establishes and protects water quality standards, prohibits the oil pollution of these waters and exacts stringent penalties if such pollution takes place, establishes a comprehensive system of water discharge permits, and authorises the US Army Corps of Engineers to issue permits for the discharge of dredged and fill material into waters of the United States. The scope of the federal government’s jurisdiction over these waters is often controversial, and the controversy continues over new regulations recently proposed by the EPA and the Corps of Engineers, seeking to clarify the definition of ‘waters of the US’ following recent decisions of the US Supreme Court. As is the case with most federal environmental statutes, many CWA powers have been delegated to state environmental agencies such as the CalEPA, subject to federal EPA oversight.

OPA is a 1990 amendment to the CWA, which increased the federal government’s authority to respond to large spills of oil into the waters of the United States. It applies to the owners and operators of onshore and offshore oil handling facilities, including oil cargo vessels, and imposes a CERCLA-like regime of joint and several and strict liability for these spills.

In 1980, CERCLA gave funding and enforcement authority to the EPA for the clean-up of sites contaminated by the spill or release of hazardous substances into the environment. Those persons or business entities determined to be ‘responsible parties’ can be held jointly and severally liable for the payment of clean-up costs on a strict liability basis; negligence need not be proven. Notably, CERCLA contains a ‘petroleum exclusion’, which excludes petroleum, crude oil and many petroleum products from the list of hazardous substances.

In addition to penalties and enforcement, CERCLA and the OPA provide for the assessment of natural resource damages resulting from such spills or releases. Specific to the oil industry, the OPA provides that responsible parties under the Act are liable for certain damages caused by an oil spill, which include damages to natural resources, real or personal property, subsistence use, lost government revenues, lost profits and earning capacity, and lost public services.

Both CERCLA and the OPA designate state and federal governments and Indian tribes as trustees over the natural resources with the obligation to act on behalf of the public to recover damages. Therefore, when natural resources are damaged due to a discharge or release, one or more trustees will be responsible for ensuring that the resources are restored to their baseline condition and that the public is compensated for the interim loss of use. For example, the National Oceanic and Atmospheric Administration (NOAA) has primary responsibility to ensure that coastal resources are restored to their original condition and use.

Air pollution discharge or emission limits that are enforced under the CAA or California air pollution control law may apply to all sources of a particular type (e.g., refinery heaters and boilers), or may be facility-specific. The CAA utilises permits to control the emission of air pollutants into the environment from industrial and commercial activities, while California and its local air pollution control agencies frequently use prohibitory rules to establish emission limits for specific categories of sources. The oil and gas sector is subject to stringent regulations in the exploration and production, transportation, petroleum refining and distribution phases of operations. California also stringently regulates the characteristics of gasoline and diesel fuel. Federal and California environmental laws regulate both new and existing sources of air pollution. New sources, including existing sources undergoing major modifications, must often comply with more stringent emissions or technology standards.

Regulations and permit conditions may include detailed record-keeping and reporting requirements. Each statute and agency has considerable penalty, injunction and criminal law remedies for non-compliance (e.g., maximum of \$37,500 per day fines and imprisonment for CAA violations and from \$10,000 per day (strict liability) to \$1 million per day (knowing violations that cause death or serious bodily injury) for California air law violations), and in some cases private parties may also recover damages or enforce public interests via citizen suits.

Waste management

The federal Solid Waste Disposal Act and its 1976 amendment known as the RCRA regulate the management and disposal of solid waste and especially hazardous waste. With respect to oil and gas operations, a number of production wastes are specifically excluded from hazardous waste regulation, and states also generally consider these wastes to be non-hazardous solid wastes. California is an exception to this general rule, and classifies oil and gas wastes as ‘non-RCRA’ or ‘California only’ hazardous wastes if they exhibit state hazardous waste characteristics. On the other hand, several petroleum refinery wastes are federally listed as hazardous wastes, and are subject to much more extensive regulation. The RCRA waste management system has been described as a ‘cradle to grave system’, requiring the observance of comprehensive permitting, record-keeping and reporting obligations. Under the RCRA, many regulatory powers have been delegated to state agencies for permitting and enforcement.

Health and safety

OCSLA authorises the US Department of the Interior (DOI) to lease offshore tracts for oil and gas exploration and development, and to regulate that development through permitting, inspections and enforcement actions. The OCSLA permitting scheme involves extensive health and safety requirements.

The federal Occupational Safety and Health Administration (OSHA), the California OSHA, and local governments all enforce rules protecting employees and contractors from workplace injuries. Record-keeping requirements can be very significant; for example, records of occupational injury must be kept for the duration of the employee’s service plus 30 years.

In addition to record-keeping requirements, OSHA also imposes certain inspection and safety programme requirements involving mechanical integrity of equipment, hazards analysis and process safety. OSHA has recently revised and strengthened the Hazard Communication Rule, which requires that workers be advised of the presence and threats of chemical products in the workplace. OSHA inspects facilities and has the power to issue citations for violations.

Decommissioning

Before abandoning a well, the operator must obtain a permit from the DOGGR confirming the manner in which the hole is plugged and abandoned or decommissioned. Security in the form of an individual surety bond or a standing bond arrangement is required. Until the permit is sought, there

is no general requirement that the operator reserve funds or otherwise prepare for decommissioning. In private contexts, however, the operator and other oil companies or the landowners may wish to establish such reservations and other protections covering decommissioning decisions.

For onshore leases on federal lands, BLM regulations require lessees or operators to submit a surety or personal bond in an amount sufficient to ensure compliance with applicable requirements including plugging of wells, reclamation of the lease area, and the restoration of land and surface waters adversely affected by lease operations upon abandonment or cessation of oil and gas operations. Bond coverage is required prior to BLM approval of any lease development activities.

For offshore leases of federal outer continental shelf lands, the BOEM requires general bonding and supplemental bonding that varies based on an annual review of the lessee’s decommissioning liability and an assessment by BOEM of the lessee’s financial resources.

The state of California through the SLC and private lessors generally addresses offshore and onshore decommissioning through lease terms. Typical provisions require the lessee to maintain a bond in favour of the state of California and to either surrender or remove all improvements, at the option of the state, upon lease termination. The lessee may retain the right to remove equipment with reuse or salvage value.

FOREIGN INVESTMENT CONSIDERATIONS

Establishment

In California, private parties generally enter into a lease and related exploration and production agreements in their own name. If there is a joint venture, it may be either a contractual arrangement in which no new entity is created; or it may be a limited or general partnership, corporation or limited liability company. Such private business organisations can be created without lengthy proceedings and without government approvals.

Under the Mineral Leasing Act, aliens may hold interests in federal onshore leases only by stock ownership in US corporations holding leases and only if the laws of their country of citizenship do not deny similar privileges to United States citizens. Aliens may not hold a lease interest through units in a publicly traded limited partnership.

OCSLA limits foreign staffing of many outer continental shelf facilities. Foreign investors must comply with record-keeping requirements of the International Investment and Trade in Services Survey Act.

Section 721 of the Defense Production Act of 1950 empowers a committee of executive branch agencies (collectively known as the Committee on Foreign Investment in the United States, or CFIUS) to investigate whether proposed foreign acquisitions of US businesses pose a risk to the national security of the United States. Upon receiving a recommendation from the CFIUS, the president is authorised to determine whether to block the proposed transaction or require divestment if the transaction has already occurred. Time periods for the filing of notices under this law and for the government to take action are elaborated on in the implementing regulations.

Amendments to the statute in 2007 expanded the review factors to include the effects of the proposed transaction on national requirements for energy sources and physically critical infrastructure 'such as major energy assets'. The impact of CFIUS review is fact-specific depending on the characteristics of the proposed acquisition.

Collaborative development or joint ownership is not considered a 'joint venture' under some applicable laws and often the agreement for collaborative operations negates the existence of a 'joint venture'. Operations by one or more parties fall into two main categories. The first is a contract to share costs and benefits from a joint undertaking, often conducted by one mineral rights owner or lessee on behalf of others with interests in the same land or in lands embracing a particular reservoir. An example is the joint operating agreement, often entered into on Association of International Petroleum Negotiators (AIPN) or Association of American Landmen (AAPL) forms. The accounting procedure under a joint operating agreement is often that specified by the Council of Petroleum Accounting Societies (COPAS). The second category consists of separate legal entities, which are typically encountered in processing, midstream and downstream applications. These entities include general or limited partnerships, corporations and limited liability companies. The particular terms of both types of agreements may substantially differ from those for a joint venture outside the US.

Capital, labour and content restrictions

Like the rest of the US, California has a relatively free regime for movement of capital and access to currencies. Foreign exchange and repatriation of income and profits are primarily matters of implementation in compliance with tax laws, including tax treaties, and compliance with the terms of applicable contracts.

There are generally no local content or local hiring requirements for oil and gas operations, except where the

work is awarded by or funded by a California or local agency and the agency imposes such a requirement.

All employers in the United States, including oil companies, must confirm each newly hired employee's identity and lawful right to work for that specific employer in the intended position. The federal laws requiring this action were established in 1986 as part of the Immigration Reform and Control Act (IRCA) and apply equally to US citizen and permanent resident workers and foreign national personnel.

When choosing to hire personnel who are neither US citizens nor lawful permanent residents (Green Card holders), it is critical for an employer to understand the rules established by the IRCA and the nature of documentation that can be presented by a foreign national to evidence their lawful right to work in the US for that specific business. Non-immigrant visas, which are temporary in nature and not intended to result in Green Card issuance, can include visitors, students, trainees and employment categories. Commonly used employment-based non-immigrant visas include:

- a. the L-1 classification used for executive, managerial or personnel with specialised skills and knowledge who are transferred within a corporate group from a location abroad to a related US subsidiary, affiliate or branch location;
- b. the H-1b classification used for positions classifiable as 'specialty-occupations', which require college-level degrees in a specific field of study to perform the duties and responsibilities of the position;
- c. the specialised visas created by treaty for citizens of Canada, Mexico, Singapore, Chile and Australia with similar standards to the H-1b classification; and
- d. the E classification for executive, managerial or personnel with essential skills and knowledge who are of the same nationality as the intended employer and are nationals of one of 82 countries with whom the US maintains specialised treaties.

In some cases a foreign national who lacks employment authorisation in the United States can enter in the B-1 (business visitor) classification to represent the interests of a foreign employer. However, that foreign national cannot provide local productive employment while in the United States, but rather can only further the goals of the company abroad.

It is also important to note many recent changes in the law regarding the use of contracted personnel. Although much

of the risk and liability associated with contract workers is maintained by the company assigning the worker, in recent years the government has increased the responsibilities, notice requirements and many of the liabilities of the company accepting the contract personnel as well.

Anti-corruption

The California Penal Code criminalises both bribery of public officials (Section 7) and ‘commercial bribery’ (Section 641.3). Under California law, it may not be necessary to establish that a particular decision of a public official was being influenced, or that the defendant had a specific intent to influence a specific decision. In addition, there are California and federal statutes and regulations on campaign finance and other aspects of participation by oil and gas companies, as well as others, in the political process.

CURRENT DEVELOPMENTS

The American Petroleum Institute in 2014 celebrated the 65th anniversary of commercial hydraulic fracturing in the United States—a topic that remains at the forefront of California oil and gas policy discussions.

The most significant industry developments in California involve the battle over who can and will regulate hydraulic fracturing at the local level. In past years, regulation of hydraulic fracturing was accomplished at the state level. Today, a number of local governments and private litigants are seeking through ordinance or court orders either to promote hydraulic fracturing, to restrict the practice, or to ban it altogether.

In February 2014, the Los Angeles City Council unanimously passed a moratorium to curb “all activity associated with well stimulation, including, but not limited to, hydraulic fracturing, gravel packing, and acidizing, or any combination thereof, and the use of waste disposal injection wells.” The moratorium motion now moves to the city attorney for development into a formal zoning ordinance (which itself will require another vote).

In May 2014, the county of Santa Cruz unanimously passed a “permanent” ban on hydraulic fracturing and all other onshore oil and gas development. There are currently no known oil leases in the county, so the move is commonly viewed as a symbolic gesture to raise awareness on the issue and put pressure on law makers at the state level. Several cities and counties have moved to put the issue of a hydraulic fracturing moratorium on the local ballot for November 2014.

In contrast, some localities have determined to provide for studies or regulations of the technique. The city of Carson’s moratorium on all new oil and gas drilling expired, and the city staff is working with oil industry representatives to develop specific safeguards. Kern County is in the process of developing an oil and gas amendment to its zoning ordinance, supported by a county-wide environmental impact report on oil and gas activities.

Additionally, several cases are currently working their way through the California courts. In a 2013 decision in a case brought by the Center for Biological Diversity (CBD), a court determined the BLM violated NEPA in failing to adequately consider the impacts of modern hydraulic fracturing practices before leasing 2,700 acres of public land atop the Monterey Shale formation. The CBD and BLM are now working on a judicially mandated joint plan of action. BLM is now planning to conduct a full environmental study for 284,000 acres of public land. Other cases have been filed by various environmental groups against DOGGR, for which a January 2014 ruling found at least one complaint to be moot and unripe while regulations under SB 4 are still being developed.

The rapid proliferation of hydraulic fracturing has caused the federal Energy Information Administration to project an increase of U.S. involvement in the global petroleum marketplace through 2040 and beyond, with California production projected to play a major role. Governor Jerry Brown is seen as seeking to explore the safe use of this technology to unleash economic value from responsible development of the state’s resources. Local efforts to restrict or promote fracking will accordingly be heavily debated and closely followed. ■